



February 17, 2011

*By electronic submission to [www.cftc.gov](http://www.cftc.gov)*

David A. Stawick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

Re: Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties (RIN 3038-AD25) (the “Proposed Rules”)

Dear Mr. Stawick:

The Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> and the International Swaps and Derivatives Association, Inc. (“ISDA”, and, together with SIFMA, the “Associations”)<sup>2</sup> appreciate the opportunity to submit this letter to the Commodity Futures Trading Commission (the “Commission”) with respect to the Commission’s proposed rules implementing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) regarding business conduct standards for swap dealers (“SDs”) and major swap participants (“MSPs”) with counterparties.<sup>3</sup> Our members comprise many of the most active participants in the swap markets and SIFMA strongly supports Dodd-Frank’s goals of increasing transparency, mitigating systemic risk, and enhancing practices in those markets.

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<sup>1</sup> SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit [www.sifma.org](http://www.sifma.org).

<sup>2</sup> ISDA, which represents participants in the privately negotiated derivatives industry, is among the world’s largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: [www.isda.org](http://www.isda.org).

<sup>3</sup> 75 Fed. Reg. 80638 (Dec. 22, 2010) (the “Proposing Release”).

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We appreciate the Commission's efforts to achieve this goal by consulting with market participants and considering industry best practices and rules and standards applicable to other markets. We are deeply concerned, however, that the Proposed Rules reflect misunderstandings of the legal and commercial contexts in which swap transactions occur and are not consistent with congressional intent, all to the detriment of the counterparties that the rules are intended to protect.

If adopted in their current form, the Proposed Rules would inappropriately transform the nature of the relationship between SDs/MSPs and their counterparties, create confusion regarding their respective responsibilities, increase counterparty dependence on SD/MSP counterparties and result in severe market disruption. By creating an overly broad concept of advice and then requiring SDs and MSPs to provide such advice, the Proposed Rules could effectively preclude participation in the over-the-counter swap markets by pension plans, municipalities and other Special Entities;<sup>4</sup> stanch the flow of important information to counterparties; introduce substantial and unnecessary uncertainty and litigation into the swap markets; and subject non-SD/MSP counterparties to unnecessary costs, execution delays, and risks. It is apparent from the legislative record that Congress took affirmative steps to avoid these consequences. We also do not believe that the Commission intends these consequences.

Additionally, the Proposed Rules would include requirements that go well beyond Dodd-Frank, and whose applications to swaps raise difficult and potentially consequential issues.<sup>5</sup> The Commission notes that it developed these provisions by looking to best practices and precedents from other markets. While we generally agree that those precedents deserve careful attention and consideration, the fact that Congress, when drafting Dodd-Frank, decided not to require rules of the sort proposed by the Commission despite their adoption in other markets should give the Commission pause, as should the extraordinarily compressed timeframe in which the Commission and industry must implement the mandatory provisions of Dodd-Frank.

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<sup>4</sup> Section 4s(h)(2)(C) of the CEA defines a "Special Entity" to include (i) a Federal Agency; (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; (iii) any employee benefit plan, as defined in Section 3 of the Employee Retirement Income Security Act of 1974 ("ERISA"); (iv) any governmental plan, as defined in Section 3 of ERISA; and (v) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986. Note that contrary to the Proposed Rules, ERISA Plans are not subject to the business conduct standards in CEA Section 4s(h)(5)(A)(i) regarding the requirements for SDs/MSPs that are counterparties to Special Entities because that provision clearly limits the applicability of those requirements to ECPs "within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18)" of the CEA. These subclauses refer to "(I) a governmental entity (including the United States, a State, or a foreign government) or political subdivision of a governmental entity" and "(II) a multinational or supranational governmental entity." Special Entities that are ERISA plans are clearly excluded.

<sup>5</sup> Dodd-Frank did not mandate requirements for an SD/MSP to "know its counterparty"; protect confidential counterparty information; refrain from "trading ahead" and "front running"; provide mid-market values; provide disclosure regarding clearing; meet institutional suitability requirements; provide a scenario analysis; comply with restrictions relating to political contributions; or satisfy prescribed execution standards.

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Accordingly, we respectfully urge the Commission to (1) adopt the recommendations described in greater detail below, which we believe would more faithfully accomplish Dodd-Frank's mandates and policy objectives and avoid the adverse consequences noted above, and (2) defer consideration of requirements not mandated by Dodd-Frank in order to afford all interested parties a more meaningful opportunity to ensure that the important issues presented are thoughtfully and appropriately addressed following completion of the Dodd-Frank mandates. At the very least, we recommend that the Commission implement any such additional proposals as self-regulatory organization ("SRO") rules<sup>6</sup> and allow sophisticated counterparties to opt out of the heightened protections that they may not need or want.<sup>7</sup>

### SUMMARY

The Commission has published the Proposed Rules pursuant to Section 4s(h) of the Commodity Exchange Act (the "CEA"), as amended by Dodd-Frank. The Proposed Rules would implement requirements under Section 4s(h) regarding: fraud, manipulation, and other abusive practices; diligent supervision; verification of counterparty eligibility; disclosure of material risks and contract characteristics; disclosure of material incentives and conflicts of interest; disclosure of daily marks; communications and fair dealing; requirements for SDs acting as advisors to Special Entities; and requirements for SDs and MSPs acting as counterparties to Special Entities. The Proposed Rules also include requirements, not mandated by Dodd-Frank, for an SD/MSP to "know its counterparty"; protect confidential counterparty information; refrain from "trading ahead" and "front running"; provide mid-market values; provide disclosure regarding clearing; meet institutional suitability requirements; provide a scenario analysis; comply with restrictions relating to political contributions; and satisfy prescribed execution standards.

The Commission explains that it has modeled the Proposed Rules on existing rules and standards applicable to market intermediaries under the CEA, Commission regulations, the federal securities laws, and SRO rules, as well as standards adopted by prudential regulators, industry best practices and requirements applicable under foreign regulatory regimes.<sup>8</sup> While the Associations agree that it is appropriate to consider rules and standards applicable in analogous contexts, as discussed below, many of the analogies implicit in the Proposed Rules do not hold up to scrutiny. Many SRO rules have their roots in retail customer protection, whereas the swap markets are almost entirely institutional. By taking those SRO rules and expanding them to apply

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<sup>6</sup> We note that many of the non-mandated requirements are actually drawn from SRO rules and the Commission has separately required SDs and MSPs to register with the National Futures Association ("NFA"). See Proposed Rulemaking, Registration of Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71379 (Nov. 23, 2010) (requiring swap entities to become and remain members of a registered futures association).

<sup>7</sup> We further recommend that, if the Commission decides that this approach is warranted, it should set the threshold to include "qualified institutional buyers" as defined in Rule 144A under the Securities Act of 1933 and corporations having total assets of \$100 million or more.

<sup>8</sup> Proposing Release at 80639.

to swaps, the Commission risks regulating the institutional swap markets more restrictively than even the retail futures and securities markets.

Many of the standards included in the Proposed Rules are inherently subjective or uncertain, or are adopted either from industry best practices or SRO Rules. By design, best practices and SRO rules seek to improve practices and are able to do so, in part, by virtue of the fact that, in going beyond legal prescriptions, they do not subject covered persons to consequences such as private rights of action or rescission actions. In contrast, the Proposed Rules would expose SDs and MSPs to private rights of action and potential rescission based on conduct standards as to which reasonable minds could differ, particularly with the “benefit” of hindsight.<sup>9</sup>

It must also be recognized that the codification of private sector aspirational standards as legal prescriptions (as opposed to best practices) will undoubtedly have a chilling effect on future private sector initiatives to enhance market practices.

Moreover, analogy to existing rules and standards is not a substitute for the effectuation of congressional intent. Many elements of the Proposed Rules would produce results that are manifestly inconsistent with clear congressional objectives. In particular, it is clear that Congress intended parties to a swap to clarify the nature of their relationship, and not to transform the nature of their relationship.<sup>10</sup> Congress also sought to establish a clear, bright line between SDs that are advisors and SDs that are merely counterparties.<sup>11</sup> Congress expressly rejected statutory provisions that would have imposed a “fiduciary duty” on an SD entering into a swap as a counterparty.<sup>12</sup> Most troublingly, the Proposed Rules would set the bar for being deemed an “advisor” or a provider of “recommendations” to mere provision of tailored information to a counterparty. As a result of the requirements to provide mid-market valuations, conduct extensive counterparty diligence and provide tailored disclosure contained elsewhere in the Proposed Rules, SD status as an advisor could, under this low bar, be a *fait accompli*. By significantly increasing the degree to which SD/MSP counterparties would rely on SDs and MSPs for services and information, the Proposed Rules would also frustrate congressional intent. The

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<sup>9</sup> See CEA Sections 22(a) (amended by Dodd-Frank to carve back existing limitations on the ability for an eligible contract participant (“ECP”) to rescind swap transactions) and 22(b) (giving participants a private right of action against a registered entity, such as an SD/MSP, if the entity violates any Commission rule).

<sup>10</sup> See, e.g., CEA Section 4s(h)(5)(A)(ii) (requiring an SD/MSP that offers to enter or enters into a swap with a Special Entity to disclose its capacity to the Special Entity before initiation of the transaction).

<sup>11</sup> Compare CEA Section 4s(h)(4) (imposing heightened duties on an SD acting as an advisor to a Special Entity) with CEA Section 4s(h)(5)(A)(i) (requiring a fiduciary independent of an SD/MSP counterparty to stand between an SD/MSP counterparty and a Special Entity).

<sup>12</sup> During the House-Senate conference, Congress struck a provision from the Senate version of H.R. 4173 that would have imposed a fiduciary duty on an SD entering into a swap as a counterparty to a defined category of governmental entities as well as pension plans, endowments and retirement plans and replaced it with the two-pronged framework described in note 10 above.

increased dependency on SDs and MSPs would lead to confusion regarding the transacting parties' relationship and discourage non-SD/MSP counterparties from conducting their own investigations and taking responsibility for their own decisions and conduct.

Put simply, under the Proposed Rules, it would be impossible for an SD to confirm to its Special Entity counterparty that it is acting merely as a counterparty and not as an advisor (as contemplated by Congress).<sup>13</sup>

The increased reliance on SDs and MSPs is particularly problematic in light of the fact that the Proposed Rules are not coordinated with the provisions of either the existing or the recently proposed Department of Labor ("DOL") fiduciary regulations.<sup>14</sup> In particular, requirements for SDs to provide scenario analyses, conduct suitability analyses, and act in the "best interests" of a Special Entity where it makes a "recommendation," among others, would likely cause SDs, in particular those who transact with an employee benefit plan subject to ERISA (an "ERISA Plan"), to fall within the definition of an ERISA "fiduciary" under the DOL Regulations.<sup>15</sup> If SDs are treated as fiduciaries under the DOL Regulations, then any swap transaction with ERISA Plans will immediately become a prohibited transaction under ERISA.<sup>16</sup> Absent a clear joint statement from the DOL and the Commission that compliance with the Proposed Rules will not result in the SD becoming a fiduciary under ERISA, there is a serious

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<sup>13</sup> Note that under the Proposed DOL Regulation, any service provider that represents or acknowledges that it is acting as a fiduciary will be treated as an ERISA fiduciary. Therefore, any imposition of fiduciary obligations on SDs would necessarily make them ERISA fiduciaries and prohibit all trades with ERISA Plans.

<sup>14</sup> The current regulation, Definition of "Fiduciary," 29 CFR § 2510.3-21(c) (1975), has been in force since 1975 (the "Current DOL Regulation"). If adopted, the proposed regulation, Definition of the Term "Fiduciary," 75 Fed Reg. 65263 (Oct. 22, 2010) (the "Proposed DOL Regulation") and, together with the Current DOL Regulation, the "DOL Regulations") would become effective 180 days after the publication of the final regulation in the Federal Register. Under the Proposed DOL Regulation, an investment adviser (as defined in section 202(a)(11) of the Investment Advisers Act of 1940 (the "Adviser Act")), whether or not registered, would be a *per se* fiduciary. All other service providers would be fiduciaries if they render any advice that is individualized and that may be used in connection with the investment decision of an employee benefit plan subject to ERISA, with a limited exception for advice where the recipient reasonably knows the advice is not impartial investment advice.

<sup>15</sup> The Proposing Release notes that DOL staff "advised that any determination of status under the Dodd-Frank Act is separate and distinct from the determination of whether an entity is a fiduciary under ERISA." Proposing Release at 80650, note 101 (emphasis added). However, it does not appear that the DOL staff or the Commission has analyzed how the fiduciary standard under either the Current DOL Regulation or the Proposed DOL Regulation would apply to the new conduct that would be required of SDs under the Proposed Rules.

<sup>16</sup> Under ERISA, a fiduciary has the duty to act prudently for the exclusive purpose of providing ERISA Plan benefits and defraying ERISA Plan costs and must not engage in conflict of interest transactions by: dealing with the assets of the ERISA Plan in its own interest or for its own account; acting in any transaction involving the ERISA Plan on behalf of a party whose interests are adverse to the interests of the ERISA Plan, its participants or beneficiaries; or receiving any consideration from a third party dealing with an ERISA Plan in connection with a transaction involving ERISA Plan assets. Furthermore, a fiduciary must not cause an ERISA Plan to engage in virtually any transaction with persons providing services to or otherwise related to an ERISA Plan, unless an exemption is available.

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risk that SDs will refuse to engage in swap transactions with an ERISA Plan to avoid the risks of costly ERISA violations, which include rescission of transactions and potentially significant excise taxes. Such a result will seriously and adversely affect the investment strategies of a \$4.7 trillion pool of investment capital in the United States. Notably, this pool of capital is already subject to extensive oversight and regulation.<sup>17</sup>

Similarly, SDs may avoid transacting with municipalities because compliance with the Proposed Rules would likely cause an SD to be deemed a “municipal advisor” under Dodd-Frank and, as a result, become subject to a fiduciary duty.<sup>18</sup> As the Commission is aware, when a fiduciary trades as principal with its client, it raises obvious conflicts of interest concerns that generally preclude such dual roles. In the context of swap transactions, the amount of realized or unrealized losses by a counterparty related to a swap are equal to the amount of realized or unrealized gains by the other counterparty in absolute terms.<sup>19</sup> To avoid this conflict, SDs may well refuse to engage in swaps with municipalities, thereby denying access to valuable investment and risk management tools for issuers of over \$2.9 trillion in securities.<sup>20</sup>

Even if the ERISA and municipal issues cited above were resolved, the Proposed Rules would likely have the unintended adverse consequence of discouraging SDs from providing Special Entities and other counterparties with education, suggestions, or other information of the kind that is customarily provided under current practice. Under the Proposed Rules, providing such information could trigger the heightened suitability requirements and, in the case of Special Entity counterparties, a “best interests” duty that would apply under the Proposed Rules to an SD making a “recommendation.” Complying with the Proposed Rules could equally give rise to common law fiduciary responsibilities.

Finally, the pre-execution requirements to conduct extensive diligence, obtain detailed representations, and provide scenario analyses and other extensive disclosure—much of which cannot be accomplished fully until the terms of the transaction have finally been agreed—will harm counterparties by adding significant costs and delays to execution, leaving Special

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<sup>17</sup> See DOL Employee Benefits Security Administration, Private Pension Plan Bulletin Historical Tables and Graphs (Dec. 2010) (giving \$4.7 trillion as the total value of pension plan assets in 2008).

<sup>18</sup> See Dodd Frank, Title IX—Investor Protections and Improvements to the Regulation of Securities, Subtitle H – Municipal Securities, §§ 975-979 (2010); Temporary Registration of Municipal Advisors, Interim Final Temporary Rule, Exchange Act Release No. 62,824, 75 Fed. Reg. 54,465 (proposed Sept. 8, 2010; effective Oct. 1, 2010). SIFMA plans to discuss the impact of an overly broad definition of “advice” and the willingness of firms to offer commercial products and services to municipal entities in its forthcoming comment letter on the SEC’s municipal advisor registration proposal.

<sup>19</sup> Even requiring a counterparty to post collateral to protect the SD could arguably violate the SD’s fiduciary duties because obtaining collateral is in the interest of the SD, not the counterparty.

<sup>20</sup> See Federal Reserve Board, Flow of Funds Accounts, Flows and Outstandings, Third Quarter 2010 (giving \$2.9 trillion as the outstanding principal amount of municipal securities).

Entities and other non-SD counterparties to pay more for swaps and exposing them to extended periods of market risk.

## DISCUSSION

For convenience, we have organized our comments and recommendations in the order in which they are discussed in the Proposing Release.

### **I. Scope**

#### **A. Swaps Traded on DCMs and SEFs**

Many of the Proposed Rules require an SD/MSP to obtain information or make disclosures to a counterparty prior to execution of a transaction. Accordingly, the Proposed Rules incorporate exceptions from specified requirements for any swap transaction (i) initiated on a designated contract market (“DCM”) or swap execution facility (“SEF”) where (ii) the SD/MSP does not know the identity of the counterparty to the transaction.<sup>21</sup>

We request that the Commission clarify that these exceptions would also apply when the SD/MSP learns of the counterparty’s identity only at or immediately before execution of the transaction, such as in the case of a swap executed using a request for quote (“RFQ”) system.<sup>22</sup> In many cases, SDs that respond to an RFQ have a limited period (in some cases measured in seconds) in which to do so and the requesting party also has a limited period (in some cases also measured in seconds) to hit or lift the actionable quote provided. Clearly, under such circumstances, compliance with pre-execution requirements simply is not possible. Similar considerations may also be presented in the context of execution arrangements not involving DCMs or SEFs where the counterparty’s identity is unknown until at or immediately before execution. Absent these clarifications, the Proposed Rules would, contrary to congressional intent, chill the use of RFQ systems and other non-anonymous SEFs for swaps subject to the CEA’s mandatory execution requirements or SEFs and other electronic execution facilities generally in the case of transactions not subject to the CEA’s mandatory execution requirement.

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<sup>21</sup> See Proposed Rule (“PR”) 23.450(c) (exception from duty to verify counterparty eligibility), 23.431(b) (exception from required disclosure of material risks, scenario analyses, material characteristics, and material incentives and conflicts of interest), 23.450(g) (exception from requirements applicable to SDs and MSPs acting as counterparties to Special Entities), and 23.451(b)(2)(iii) (exception from the pay to play prohibition). The exception from the duty to verify counterparty eligibility would not apply to a swap transaction initiated on a DCM, even though Dodd-Frank contemplates that even non-ECPs could trade swaps over a DCM.

<sup>22</sup> The Commission has separately proposed that RFQ systems would qualify as SEFs. See 76 Fed. Reg. 1214 (Jan. 7, 2011).

*B. Existing Swaps*

We also request that the Commission confirm that the Proposed Rules would not apply to unexpired swaps executed prior to the effective date of final rules. To do otherwise would interfere with the rights and obligations of counterparties under existing, individually negotiated contracts. For instance, the duty of an SD/MSP to know its counterparty should not apply to counterparties to existing swaps, since such a duty is clearly intended to inform the SD/MSP when establishing a new trading relationship.

**II. Know Your Counterparty**

Although there is no such requirement in Dodd-Frank, PR 23.402(c) would require an SD/MSP to use reasonable due diligence to know and retain a record of the essential facts concerning a counterparty, including facts necessary to (i) comply with applicable laws, regulations, and rules, (ii) effectively service the counterparty, (iii) implement any special instructions from the counterparty and (iv) evaluate the previous swaps experience, financial wherewithal and flexibility, trading objectives and purposes of the counterparty.<sup>23</sup>

The Commission notes that PR 23.402(c) is based in part on NFA Compliance Rule 2-30 (Customer Information and Risk Disclosure).<sup>24</sup> It also appears to draw from Financial Industry Regulatory Authority, Inc. (“FINRA”) Rule 2090 (Know Your Customer). PR 23.402(c), however, departs from these SRO precedents in several critical ways.

PR 23.402(c) would require an SD/MSP to conduct an independent investigation in order to obtain information necessary to “evaluate” a counterparty’s “flexibility.” This requirement, whose meaning is in any event unclear, is not found in either NFA Compliance Rule 2-30 or FINRA Rule 2090. Moreover, like other provisions in the Proposed Rules, PR 23.402(c) would require the SD/MSP to obtain extensive information about its counterparty as part of an evaluative inquiry that would, in many respects, only be appropriate in the context of an advisory relationship. As a corollary, in the context of a relationship that the parties each regard as a counterparty relationship and not an advisory relationship, it puts the SD/MSP in the position of making unwelcome, awkward, intrusive and time-consuming inquiries for information that, notwithstanding the confidentiality obligations of the SD/MSP, the counterparty will not want to share with the SD/MSP. The evaluative component of PR 23.402(c) would additionally put the SD/MSP in the awkward and untenable position of second guessing its counterparty’s representations about the types of transactions it would be willing to enter into and its objectives in entering into those transactions. The Commission must recognize that, like the inquiries necessary to fulfill many other duties it has proposed, such inquiries can take substantial time and effort and involve non-trivial costs. The Commission must also recognize that PR 23.402(c),

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<sup>23</sup> An SD/MSP would also be required to keep a record of the true name, address, and certain other information regarding the counterparty. PR 23.402(d).

<sup>24</sup> Proposing Release at 80641.



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especially in combination with the disclosure and suitability requirements described below, would effectively mandate that an SD/MSP act as a *de facto* advisor to its arm's length counterparty, contrary to the express provisions and objectives of Dodd-Frank.

PR 23.402(c) would also impose unclear, new, extra-contractual obligations that have no basis under Dodd-Frank. For example, an SD/MSP would have to use reasonable due diligence to obtain the facts necessary to "effectively service the counterparty" or "implement any special instructions from the counterparty." Ignoring the uncertainty that exists regarding the level and scope of the diligence that would be required under this proposal or what standard is implied by the requirement to "effectively service," we are not aware of any provision of Dodd-Frank or any other law that would require an SD/MSP to "effectively service" a counterparty or to implement counterparty instructions. Any such legal requirement seems to be drawn from an agency context, and would clearly be out of place in an arm's-length, principal-to-principal relationship, where the parties do not assume obligations to each other additional to those expressly agreed in their contracts.

Additionally, the Commission's proposals would constitute a Commission regulation, not an SRO rule. This is problematic precisely because PR 23.402(c), by design, would impose a duty that involves subjective judgment, rather than a clear objective standard.<sup>25</sup> Subjective duties imposed as an SRO rule are enforceable solely by the Commission or an SRO. However, as a Commission regulation, a subjective duty necessarily gives rise to significant private litigation risk (for rescission and/or recovery of transaction losses). The uncertainty and the potential costs associated with such heightened litigation risk could chill otherwise desirable activity.

In adopting and broadening SRO rules adopted to protect retail customers, the Commission would inappropriately regulate a sophisticated institutional market more stringently than markets dominated by retail customers.

In light of the foregoing, and the fact that Dodd-Frank does not mandate these provisions, we recommend that the Commission not adopt this proposed requirement. If the Commission nonetheless decides to adopt this rule at this time, consistent with analogous regulatory precedents, we recommend that any diligence standard of the type contemplated by the Commission (subject to appropriate modification as noted above) be implemented as an SRO rule (and not as a Commission regulation).

### **III. Fraud, Manipulation and Other Abusive Practices**

Pursuant to its discretionary authority under Section 4s(h)(1) of the CEA to promulgate rules related to fraud, manipulation and other abusive practices, the Commission proposes to adopt the prohibitions contained in Section 4s(h)(4)(A) of the CEA as PR 23.410(a),

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<sup>25</sup> FINRA expressly acknowledged this when proposing Rule 2090. See 75 Fed. Reg. 52562 (Aug. 26, 2010) at 52566.

but would expand those prohibitions to cover conduct of an SD/MSP acting as a mere counterparty—even where it is not acting as an advisor. This expansion of Section 4s(h)(4)(A) to cover mere counterparties clearly contradicts congressional intent. As the Commission is aware, Section 4s(h)(4) is expressly entitled, “Special Requirements for Swap Dealers Acting as Advisors” (emphasis added). Although, as the Commission notes, the prohibitions contained in Section 4s(h)(4)(A) do not themselves contain language limiting them to instances where an SD is acting as an advisor, that is because such language would have been superfluous given the title of that section. The absence of such language in the prohibitions themselves does not provide a basis for reading the limitation out of the statute.

This expansion is particularly troubling in the context of PR 23.410(a)(3), which would prohibit an SD/MSP from engaging “in any act, practice, or course of business that is fraudulent, deceptive, or manipulative” and which, under the Commission’s interpretation, would not require scienter to prove liability.<sup>26</sup> The Commission explains that there should not be a scienter requirement for PR 23.401(a)(3) because “[t]his language mirrors the language in Section 206(4) of the [Advisers Act][], which does not require scienter to prove liability.”<sup>27</sup> While we agree that Section 4s(h)(4)(A)(iii) adopts the language of Section 206(4) of the Advisers Act, we emphasize that it does so, quite logically, only in the context of an SD acting as an advisor to the counterparty. Therefore, the analogy to the Advisers Act, specifically to its lack of a scienter requirement, breaks down in the context of an SD acting in a non-advisory capacity.

In our view, a more apt analogy in non-advisory contexts would be to Rule 10b-5 under the Securities Exchange Act of 1934 (the “SEA”), which does in fact require scienter to prove liability.<sup>28</sup> With this in mind, we respectfully recommend that the Commission adopt a scienter requirement when an SD/MSP acts merely as a counterparty to a non-Special Entity and does not act as an advisor. As is the case with Rule 10b-5, it would be unfair to subject a non-advisor-SD/MSP to liability without any showing of bad faith.

#### **IV. Confidential Treatment of Counterparty Information**

Although not mandated by Dodd-Frank, PR 23.410(b) would prohibit an SD/MSP from disclosing any material confidential information obtained from a counterparty unless (i) such disclosure is necessary for the effective execution of any swap or to hedge any exposure created by such swap and the counterparty specifically consents to such disclosure; or (ii) the Commission, Department of Justice, or an applicable prudential regulator requests such information. This rule would thus significantly restrict counterparties’ rights to consent to disclosure.

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<sup>26</sup> Proposing Release at 80642, note 31.

<sup>27</sup> Id.

<sup>28</sup> See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 (2007) (“To establish liability under § 10(b) and Rule 10b-5, a private plaintiff must prove that the defendant acted with scienter, ‘a mental state embracing intent to deceive, manipulate, or defraud.’” (citation omitted)).

The definition, treatment, use, and disclosure of confidential information are customarily negotiated by the parties to swap transactions. Counterparties extensively negotiate the transactional information that is considered confidential as well as the circumstances in which such information may be used by the recipient or disclosed (either to third parties or the recipient's own personnel). Aspects of a transaction may be highly sensitive (and therefore treated as confidential) in some contexts and not in others.

Similarly, the use and disclosure restrictions agreed to by parties may be transaction-specific and otherwise may be either more restrictive or more expansive than the Commission's proposed standard, although in our members' experience counterparties generally include more expansive exceptions than the Commission has proposed for disclosure to regulators, service providers or other parties subject to confidentiality obligations. It is often necessary to disclose information to revenue or taxing authorities or to regulators other than the Commission, Department of Justice, or a prudential regulator, since many SDs and MSPs registered with the Commission may also be subject to the jurisdiction of the Securities and Exchange Commission (the "SEC"), one or more SROs, state attorneys general, or state or foreign regulators. Disclosure should also not be proscribed by Commission regulation when made pursuant to any legal or regulatory process, action or proceeding. Other types of disclosure may also be relevant depending on the specific circumstances of the parties to a transaction.

At bottom, the Commission's unprecedented proposal would effectively convert contractual confidentiality obligations to a federal law and put the Commission in the position of interpreting the parties' intent under private contracts. Given the lack of an express statutory mandate for this proposal, the absence of any relevant precedent, and the need for flexibility in this area, it is not clear why this is necessary or appropriate.

Accordingly, we respectfully recommend that the Commission leave confidentiality of counterparty information to contractual negotiation and enforcement and delete PR 23.410(b) from the Proposed Rules. If, however, the Commission believes it necessary to retain federal protection of counterparty confidential information, we recommend that the Commission alternatively require SDs and MSPs to establish, maintain, and enforce policies and procedures reasonably designed to prevent the improper use or disclosure of any counterparty information that the SD/MSP has agreed with the counterparty to keep confidential. Additionally, the parties' contractual right to consent to disclosure should not be limited, as it is under current PR 23.410(b), to the narrow circumstances where "disclosure is necessary for the effective execution of any swap for or with the counterparty or to hedge any exposure created by such swap."

## **V. Trading Ahead and Front Running**

PR 23.410(c) would, despite any such prohibition in Dodd-Frank, make it unlawful for any SD/MSP to enter "knowingly" and without "specific" counterparty consent into a "transaction" for its own benefit ahead of (i) any executable order for a swap received from a counterparty or (ii) any swap that is the subject of a negotiation with a counterparty.

In explaining this provision, the Commission analogizes to prohibitions applicable to introducing brokers (“IBs”) and futures commission merchants (“FCMs”).<sup>29</sup> We have two significant concerns with this analogy.

First, while the analogy may be appropriate when an SD/MSP is, like an IB or FCM, acting as agent for a counterparty and therefore has a duty to that counterparty, the analogy breaks down when the SD/MSP is acting as principal for its own account, and the issues become more nuanced and complex. In contrast, front running rules in other non-agency contexts, such as with respect to securities dealers, tend to prohibit persons in possession of material non-public information concerning an imminent block transaction from trading in the relevant security or related securities and securities derivatives (subject to certain exceptions), and do not impose unrestricted *per se* prohibitions on transactions generally.<sup>30</sup>

Additionally, the proposed prohibition on trading during the negotiation of a swap fails to appreciate the fundamental distinction between bilaterally negotiated swaps, on the one hand, and orders for standardized products (such as futures and securities), on the other hand. In contrast to the futures and securities markets—where parties only need to agree on which contract/security is being bought/sold and the price and size of the transaction—in the largely bilateral swap markets many more terms must be negotiated. In this context we note that the communications leading up to a swap transaction are not analogous to receipt of an order. For futures and securities, whether an “order” is subject to a front running prohibition depends entirely on where the order is priced in relation to the prevailing inside market. There is no uncertainty arising from transaction terms that are still under negotiation and may change in the future or the likelihood of execution. This is not the case in the context of swaps. Swaps can take weeks or months to negotiate. During this period it is not only uncertain what the ultimate terms of the swap will be, it is also unclear whether the swap will be executed at all, or with the relevant SD/MSP, or when it will be executed. Indeed, counterparties usually negotiate with multiple dealers to obtain better pricing. This negotiation process is more akin to a protracted price discovery process than it is to the handling of an imminent order. Enforcing a so-called “front running” ban during this potentially extended and uncertain period of negotiation would be plainly untenable and disruptive to the market. It would also undermine SD/MSP safety and soundness to the extent it prevents hedging activity (either relating to the pending transaction or other assets or liabilities of the SD/MSP).

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<sup>29</sup> Proposing Release at 80642.

<sup>30</sup> See, e.g., NASD IM-2110-3; see also NYSE Arca Equities Rule 6.6, CBOE Rule 6.9(e), NASDAQ OMX PHLX Rule 1064, and ISE Rule 400.02 (imposing similar prohibitions). In 2008, FINRA proposed to replace NASD IM-2110-3 with new FINRA Rule 5270, which would have broadened the scope of the rule and codified certain interpretive positions. See FINRA Regulatory Notice 08-83. We note that our recommendations in this letter are intended to be consistent with the recommendations contained in our comments on that proposal. See Letter from Ann Vlcek and Gerald Quinn, Managing Directors and Associate General Counsels, SIFMA, to Marcia E. Asquith, Office of the Corporate Secretary, FINRA, dated Feb. 27, 2009.

Accordingly, and in light of the fact that Dodd-Frank does not mandate that the Commission adopt trading ahead and front running prohibitions, we respectfully recommend that the Commission not adopt its proposed prohibitions. The Commission should defer adoption of any prohibitions until it can address the more nuanced issues that such prohibitions present in a more measured timeframe.

If, however, the Commission determines it necessary to adopt front running and trading ahead prohibitions for SDs and MSPS at this time, those prohibitions should only apply when the SD/MSP has received an executable order, and should not apply to a swap that is still subject to negotiation. Accordingly, we respectfully recommend that the Commission prohibit only a transaction that (1) is entered into for a non-hedging purpose on the basis of actual knowledge of a non-public, executable order of a counterparty, (2) exhibits consistent and estimable positive price correlation to the pending executable counterparty swap transaction and (3) whose execution is substantially likely to materially affect the price of that pending executable swap transaction. Finally, the Commission should clarify its proposed “specific” consent standard and the duration of the prohibition.

Adopting these changes would clarify the following:

- **Knowledge.** The person directing the transaction in question would be required to have actual knowledge of a non-public, executable order for the front running prohibition to apply. There is no reason to prohibit transactions made by other parts of an organization that are not privy to the counterparty’s order.
- **Trades not based on executable orders.** Trades that are not based on pending executable orders would be permitted, such as: (1) when an SD/MSP enters into a trade at the request of another customer;<sup>31</sup> (2) when the specifics of a pending swap transaction are still undefined; (3) when an automated trading program is used to make either of the transactions in question; or (4) an SD/MSP enters into a trade in the ordinary course of hedging other transactions, assets or liabilities.
- **Clearly defined nexus between transactions.** The broad prohibition against any “transaction”—which clearly restricts a far greater range of activity than is workable, necessary, or intended—would be replaced with a restriction on only those transactions with a clearly defined (i.e., price-correlated) nexus to the pending swap transaction.

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<sup>31</sup> Without this clarification, the rule would penalize other customers because the SD/MSP may refrain from executing their orders or delay execution to avoid the appearance of trading ahead or front running. For instance, the same trading desk should be permitted to negotiate, enter into and hedge similar transactions with more than one counterparty. It is of course entirely possible to have multiple customers requesting similar trades on the same underlying within a short period of time, especially following a news event.

- **Adverse effect on the counterparty.** If a transaction would not adversely affect the counterparty, it would not be prohibited. For example, an SD/MSP would not be prohibited from engaging in a technically correlated transaction that, as a practical matter, would not affect the counterparty (e.g., a swap on the S&P 500 index would not adversely affect a small imminent swap on one of its constituent stocks).
- **Hedging transactions.** Anticipatory hedging transactions would be permitted. Given that SDs and MSPs usually engage in swaps as principal, committing their own capital to such transactions, it is essential that they be permitted to offset this risk through such transactions. To ensure that counterparties are aware of potential hedging before entering into a transaction, swap market participants typically use disclosure forms to document acknowledgements and agreements regarding the extent to which hedging may or may not occur in connection with a transaction.<sup>32</sup> The Commission should preserve this disclosure-based approach for anticipatory hedging by permitting an SD/MSP to engage in transactions hedging (on a transaction-by-transaction or portfolio basis) any pending swap transaction to be entered into by the SD/MSP on a principal-to-principal basis, subject to appropriate disclosure to the counterparty in the transaction documentation.
- **Specific consent standard.** For permitted transactions other than anticipatory hedging, the Commission should confirm that the proposed requirement for “specific” consent requires only the express consent to trade without regard to this restriction and does not require approval of specific transactions at specific times.
- **Duration of prohibition.** The prohibition should apply only until the pending transaction is executed or cancelled, or the relevant information ceases to be material non-public information.

The Commission has also requested comment as to whether an SD/MSP should be required to disclose to a counterparty its pre-existing positions in a type of swap prior to entering into the same type of swap with the counterparty.<sup>33</sup> The proposed disclosure would be inappropriate for a variety of reasons.

First, under common law principles, persons occupying the position of a dealer or principal counterparty have no common law duty of disclosure. In contrast, an advisor or fiduciary providing advice would have a duty to disclose facts that create a conflict of interest that would interfere with its duty to act in the best interests of its client. Conflating the two roles

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<sup>32</sup> See, e.g. Section 13.4(c) of the 2002 ISDA Equity Derivatives Definitions (“[T]he other party . . . may . . . engage in proprietary trading . . . (including such trading as such party/and or its Affiliates deem appropriate in their sole discretion to hedge their market risk on such Transaction and other transactions . . .”).

<sup>33</sup> Proposing Release at 80642.

would undermine Congress' objectives under Dodd-Frank, which seeks to treat advisors differently than mere counterparties.

Second, no legitimate policy objective would be furthered by encouraging market participants to make decisions as to what they trade on the basis of positions an SD/MSP may or may not have assumed (and, in particular, that are in place for reasons that would be undisclosed). Market participants should be making trading decisions based on their own analysis and objectives, and on the advice of their chosen advisors.

Third, if an SD/MSP discloses its pre-existing positions, the counterparty will learn, or often be able to discern, confidential information about positions, transactions or strategies of the SD/MSP's other counterparties or clients (not to mention of the SD/MSP itself and its affiliates, who equally have a legitimate expectation of privacy). Indeed, depending on the scope of the requirement, it could even require disclosure of confidential information subject to informational barriers, a result plainly at odds with the Commission's policy objectives.

Fourth, any such disclosure has enormous potential to be misleading. Suppose that the Commission's requirement results in disclosure of a large block-size position of an SD on the opposite side of the market. Suppose further that the counterparty decides not to proceed with its contemplated transaction based on its inference that the SD believes it best to be long. Finally, suppose that the SD was actually block positioning inventory in anticipation of a block transaction with a customer that intends to hedge a related risk. In one fell swoop, the Commission's disclosure requirement would have succeeded in disrupting market activity, misleading the market participant it intended to protect, encouraging socially undesirable dependencies and lack of responsible market behavior, and potentially compromised the confidentiality of an unrelated party's business information in violation of other proposed Commission requirements.<sup>34</sup>

Fifth, any such requirement would seriously discourage an SD from providing liquidity, since disclosure of its pre-existing positions would expose the SD to unnecessary risk and /or compromise its own business information and/or trading strategies. The requirement could also foster undesirable conduct such as feigned interest in a transaction in order to conduct a "fishing expedition" for information about the SD/MSP's positions in the relevant instrument.

Finally, for non-standard or bespoke swaps, it would be entirely unclear which pre-existing positions the SD/MSP would be required to disclose.

## **VI. Verification of Counterparty Eligibility**

PR 23.430(a) and (b) would require an SD/MSP to verify that a counterparty is an ECP and determine whether a counterparty is a Special Entity prior to offering or entering into a swap. We believe that an SD/MSP should be permitted to satisfy this requirement by relying on

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<sup>34</sup> See PR 23.410(b) (proposed confidentiality obligation).

written representations by the counterparty as to the counterparty's status as an ECP and Special Entity, absent actual notice of countervailing facts (or facts that reasonably should have put the SD/MSP on notice), which would trigger a consequent duty to inquire further. The SD/MSP should not be required to affirmatively investigate the counterparty's representations or to obtain detailed representations as to the facts underlying the counterparty's qualifications.

This approach is consistent with that adopted under all analogous regulatory contexts of which we are aware and comports with current practice across the financial markets for non-retail transactions.<sup>35</sup> Although the Commission's proposed formulation of the "reasonable basis to believe" standard (here and in other provisions of the Proposed Rules) sounds similar, it is, in reality, the antithesis of the approach summarized above. Under the Commission's proposed approach, an SD/MSP must conduct affirmative diligence in order to determine whether it is reasonable to rely on provided representations. Such an approach effectively makes the relevant representation(s) superfluous. The very purpose of the representations is to entitle the SD/MSP to rely upon them, unless it would be unreasonable for the SD/MSP to do so under the circumstances, in light of other facts actually known to the SD/MSP's relevant personnel that would give rise to a further duty of inquiry.

The Commission has also requested comment on whether there should be an ongoing duty to verify eligibility.<sup>36</sup> We believe that, with regard to an outstanding swap, the SD/MSP should not be obligated to continue to verify that the counterparty is an ECP. Eligibility status should only be relevant in the context of determining whether the counterparty is sophisticated enough to enter into an over-the-counter swap at the time of execution. Introducing an ongoing verification duty would give rise to additional complexities: would loss of ECP status limit the counterparty's ability to terminate the transaction? Modify it? Novate it? Any such limitations would be detrimental to the very parties that the Commission seeks to protect. With regard to new swaps, the SD/MSP should be able to rely on a master agreement that contains (1) a counterparty eligibility representation that is deemed to be made at the inception of each swap transaction and (2) a covenant that the counterparty will notify the SD/MSP if it ceases to be an ECP.

## **VII. Disclosure of Material Information**

### **A. Material Risks**

PR 23.431(a)(1) would require an SD/MSP to provide a counterparty (other than another SD/MSP) with disclosure reasonably designed to allow the counterparty to assess the material risks of the "particular" swap, which may include market, credit, liquidity, foreign currency, legal, operational and any other applicable risks. Although PR 23.402(g) would permit the parties to a swap to agree to provide the required information in any reasonable manner

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<sup>35</sup> Such contexts include Regulation D and Rule 144A under the Securities Act of 1933.

<sup>36</sup> Proposing Release at 80642.



(including a master agreement between the parties, which may satisfy the requirements for subsequent swaps), the Proposing Release notes that “it is unlikely” that standardized disclosure would be adequate to meet all disclosure duties, as, in its view, most bespoke transactions would “require some combination of standardized and particularized disclosures.”<sup>37</sup>

Dodd-Frank requires the Commission to adopt rules that require an SD/MSP to disclose “information about” the material risks and characteristics of the swap. The Commission has interpreted the term “information about” to mean “information . . . reasonably designed to allow a counterparty to assess . . . the materials risks of a particular swap.” We believe that the Commission has improperly expanded the statutory mandate from a simple requirement that could readily be satisfied by a standardized disclosure that could be developed by the Commission with the assistance of SROs and industry participants (much like the disclosures for futures and options)<sup>38</sup> into an unbounded “advisor-like” disclosure obligation that will increase costs, delay execution, expose parties to additional market risks, intrude on counterparty confidential information and result in ever longer lists of hypothetical risks (the sheer volume of which might actually prevent counterparties from effectively identifying material risks). We are particularly concerned since “information . . . reasonably designed to allow a counterparty to assess . . . the materials risks of a particular swap” could be read to require that the SD/MSP:

- Identify and disclose any conceivable event that could materially affect the performance of the swap (e.g., a particular event in the Middle East that could impact currency markets); and
- Investigate in detail the purpose for which the swap is used by the counterparty and identify and disclose the risks based on that purpose. For example, suppose that a pension plan proposes a swap to an SD/MSP designed to correlate the duration of the pension plan’s assets and its liabilities (a liability-driven investment strategy), would the SD/MSP have to warn about the actuarial assumptions used to value the plan’s liabilities, the competence of the plan’s actuaries and the basis risks of adjusting asset duration to match these liabilities?

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<sup>37</sup> Proposing Release at 80642.

<sup>38</sup> See, e.g., Rule 9b-1 under the SEA (requiring that a broker-dealer, before or at the time it approves a customer’s account or accepts the customer’s order to trade options, disclose to the customer certain general information, including a discussion of the mechanics of exercising the options and a general identification of the type of instrument or instruments underlying the options class or classes covered by the document); “Characteristics & Risks of Standardized Options,” Options Clearing Corporation (options disclosure document for exchange-traded options); CFTC Rule 1.55 (specifying standardized, general language that must be furnished to a customer opening a commodity futures account, although a statement approved by one or more foreign regulatory agencies or self-regulatory agencies may also be used); CFTC Rule 32.5 (specifying both general terms that must be included and standardized language that a person soliciting or accepting an order of commodity options must provide to their counterparty); CFTC Rule 33.7(b) (stipulating standardized language to be furnished to a client opening or causing the opening of a commodity option account, in the event the FCM does not seek the CFTC’s approval of another statement); and CFTC Rule 190.10(c) (stipulating standardized, general language that a commodity broker must furnish to a customer in order to accept non-cash property to margin, guarantee, or secure a commodity contract).

Counterparties hire qualified representatives whose job it is to assess precisely the role that the swap plays in connection with the investment portfolio of the counterparty. Tailored risk disclosure puts the SD/MSP in the role of an advisor charged with identifying all potential adverse circumstances that could arise, even in circumstances where the swap criteria and swap terms were proposed by the counterparty or its advisor.<sup>39</sup> We do not believe that this result was intended, nor do we believe that its effect will be desirable. Because it will take an SD/MSP time to investigate adequately all the facts necessary to discharge a tailored disclosure obligation, the proposal will increase costs and give rise to delays in execution that will put the counterparty at market risk, even in circumstances in which the disclosure is not needed, requested or desired. While the Commission points to best practices to support this interpretation, as we mentioned elsewhere, turning best practices into rules of law subject to enforcement in a private litigation brought with the benefit of investment hindsight has numerous adverse and unintended consequences. Moreover, the nature and level of detail seemingly required by these disclosure rules is yet another example of the Commission regulating the largely institutional swap markets more stringently than retail markets.

We therefore believe that standard disclosure templates will be essential in satisfying the risk and other disclosure requirements of Dodd-Frank. Standard disclosure will facilitate consistent practices and disclosure quality across market participants, while providing an efficient and cost-effective mechanism for registrants to satisfy their new statutory obligations. It is possible to address the risks associated with many bespoke transactions in standardized disclosure templates. For example, a standardized disclosure format could adequately anticipate and disclose the liquidity and related market risks that might result from the customization of a swap to use non-conventional settlement dates. As a result, we recommend that the Commission not establish a presumption that a bespoke transaction requires non-standardized disclosure.

*B. Scenario Analysis*

PR 23.431(a)(1)(i) (another rule not mandated by Dodd-Frank) would require an SD/MSP, in the case of a bilateral swap that is not available for trading on a DCM or SEF, to (i) notify its non-SD/MSP counterparty that it may request scenario analyses and (ii) provide such scenario analyses upon request. Additionally, for “high-risk complex bilateral swaps,” PR 23.431(a)(1)(ii) would require an SD/MSP to provide scenario analyses designed in consultation with the counterparty to allow the counterparty to assess its potential exposure in connection with the swap.

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<sup>39</sup> If the Commission were to require such tailored risk disclosure, then it should do so only in cases where the SD/MSP provides advice or makes recommendations to a counterparty, pursuant to a mutual written agreement that such advice or recommendations will serve as a primary basis for the counterparty’s investment decisions, and that the advice will be individualized based on the particular needs of the counterparty. This would prevent the disclosure requirement from triggering fiduciary or other advisory status except in circumstances where that status reflects the actual nature of the parties’ relationship.

The Proposing Release explains that the proposed scenario analysis requirements were modeled on the Counterparty Risk Management Policy Group III industry best practices recommendation for high-risk complex financial instruments.<sup>40</sup> While the Associations support disclosure of scenario analysis for specified swaps as a best practice in appropriate circumstances, we do not believe that the Commission should impose such a requirement as a matter of federal regulation in all circumstances. As noted above, the codification of best practices as federal regulation without consideration of the differences between the two would likely, in the future, discourage private sector initiatives to establish best practices that involve difficult and subjective judgments.

The most pressing practical issue presented by the proposed scenario analysis requirements is defining the type of analysis required. The term “scenario analysis” encompasses many different types of analyses, including the modeling of a broad range of political, economic, and other events beyond changes in the levels of underlying market factors. Although the Proposed Rules and the Proposing Release suggest that the term scenario analysis is limited to stressing the levels of the underlying market factors,<sup>41</sup> they go on to require that the SD/MSP consider any relevant internal risk analyses, including analyses performed as part of its new product policy.<sup>42</sup> The Proposing Release further requests comment regarding whether a Value at Risk analysis should be part of the mandatory scenario analysis.

Disclosure of analyses more elaborate than stressing the levels of the underlying market factors would go beyond risk disclosure and incorporate extremely complex and subjective judgments about the probable or possible future market states and their relevance to a particular transaction. While such analyses may be appropriate for internal risk management purposes, they are calibrated and used for those purposes, generally on a portfolio basis, and with full knowledge of their limitations and subject to ongoing supervision by prudential regulators. Such internal risk management analyses are simply not relevant for third parties in the context of individual transactions. The level of additional disclosures that would be needed to ensure that the disclosure of such a more elaborate analysis to a third party is not misleading should call into question the utility of requiring that the analysis be provided in the first place. This issue also underscores our overall concern that this rule will increase the degree to which counterparties depend on SDs/MSPs for information and thrust SDs/MSPs further into the performance of advisory responsibilities.

The Commission’s proposed scenario analysis requirements raise many issues when considered in combination with the DOL Regulations, the CTA provisions of the CEA, Dodd-Frank’s municipal advisor provisions, and other aspects of the Proposed Rules. Providing a scenario analysis could cause an SD/MSP to be treated as a fiduciary under the DOL

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<sup>40</sup> Proposing Release at 80644.

<sup>41</sup> See PR 23.431(a)(1)(ii) and Proposing Release at 80644, note 53 and accompanying text.

<sup>42</sup> PR 23.431(a)(1)(v) and Proposing Release at 80644, note 55 and accompanying text.

Regulations<sup>43</sup> or become subject to the CTA provisions of the CEA or Dodd-Frank's municipal advisor provisions because a scenario analysis is clearly intended to be used in connection with (and perhaps may be used as a primary basis for) an investment decision. Similarly, disclosure of a scenario analysis could be viewed as a "recommendation" to the counterparty (regarding the range of market moves it should consider likely or worth considering), which could trigger the Proposed Rules' heightened suitability requirement and "best interests" duties.

Additionally, although PR 23.431(a)(1)(iii) would require an SD/MSP to use reasonable policies and procedures to identify whether a bilateral swap is a high-risk complex bilateral swap based on specified characteristics, the Proposed Rules would nevertheless subject the SD/MSP to an unqualified duty to provide a scenario analysis for any bilateral swap deemed to be a high-risk complex bilateral swap. As a result, the Proposed Rules, read literally, could subject the SD/MSP to liability (including to its counterparties) for failing to provide a scenario analysis if the SD/MSP's own rule-compliant policies and procedures did not identify the swap as a high-risk complex bilateral swap. This is particularly problematic given the CFTC's highly subjective definition of high-risk complex bilateral swap.

The Proposed Rules would also require performance and disclosure of a scenario analysis for a high-risk complex bilateral swap even in circumstances when the counterparty neither requests nor wants such an analysis.<sup>44</sup> Since an appropriate scenario analysis cannot be performed until the terms of the transaction have been agreed (and indeed it may not even be possible to determine whether a scenario analysis would be required until such time), this would unduly delay execution and consequently expose counterparties to ongoing market risk for an extended period of time. Requiring scenario analyses to be performed and disclosed for an even wider range of transactions, as suggested in the Proposing Release's request for comments, would only serve to compound this problem.<sup>45</sup>

If the Commission chooses to proceed with the rule despite the foregoing implications and the absence of a statutory mandate, we recommend that the Commission to make the following modifications:

- **Definition of scenario analysis.** The Commission should clarify that scenario analyses would be limited to a presentation of the range of terminal value

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<sup>43</sup> In the ERISA context, in order to qualify for the counterparty exception under the Proposed DOL Regulation, the SD/MSP would have to ensure that the counterparty knows that, in providing the scenario analysis, the SD/MSP is not providing "impartial advice," a proposition that is simply not feasible or sensible.

<sup>44</sup> There are many instances where a sophisticated institutional counterparty will not want or need scenario analyses, even for swaps designated as high-risk complex bilateral swaps. The counterparty, for example, may have entered into this kind of swap many times before and thus be familiar with the associated risks, or the counterparty may have access to advisors or analytical tools or otherwise be able to and wish to conduct its own scenario analyses.

<sup>45</sup> See Proposing Release at 80645 (requesting comment whether scenario analyses should be required for all swaps not accepted for clearing or that are uncleared).

outcomes that would result from specified market levels for the market factor(s) underlying the relevant swap. Internal risk analyses, including any Value at Risk analysis, should not be required to be provided. Additionally, the specific terminal market levels to be presented should be limited to those specified by the swap counterparty and the SD/MSP should not be responsible for evaluating the counterparty's choice of terminal market levels.

- **Obligation to provide scenario analyses.** An SD/MSP should only be required to provide a scenario analysis for a high-risk complex bilateral swap in a case where the counterparty requests the scenario analysis and specifies the outcomes it wishes to have covered. An SD/MSP would be required, as currently proposed, to notify its counterparty that it may request a scenario analysis for a high risk complex bilateral swap and should further be required to establish, maintain, and enforce policies and procedures to perform and provide a scenario analysis in accordance with parameters specified by the counterparty requesting such an analysis.
- **Fiduciary/advisory concerns.** Additionally, the Commission should obtain express DOL and SEC confirmation that the performance of a scenario analysis would not cause the SD/MSP to become a fiduciary under the DOL Regulations or a municipal advisor, respectively. The Commission should also confirm that performance of a scenario analysis would not trigger a heightened suitability obligation or a best interests duty under its own regulations or subject an SD/MSP to the CEA's CTA provisions.

C. Material Characteristics

Under PR 23.431(a)(2), an SD/MSP would be required to provide a counterparty (other than another SD/MSP) with disclosure reasonably designed to allow the counterparty to assess the material characteristics of the particular swap, including the material economic terms of the swap, the terms relating to the operation of the swap, and the rights and obligations of the parties during the term of the swap.

Just as with the Commission's proposed material risk disclosure requirement, the Proposed Rules have expanded Dodd-Frank's requirement for disclosure of "information about" the characteristics of the swap to instead require disclosure of "information . . . reasonably designed to allow a counterparty to assess . . . the material characteristics of the particular swap," with similar adverse consequences.

Moreover, since any description of a swap's characteristics other than the swap's terms is inherently (indeed, by definition) less accurate than the swap terms themselves, we recommend that the Commission clarify that this disclosure requirement is satisfied when a counterparty has or is provided with a copy of each item of documentation that governs the terms of its swaps with the SD/MSP. This would include copies of the master agreement, schedule, confirmation, and related documentation subscribed to by the counterparty.

A contrary requirement to provide a summary of contract characteristics is not only unnecessary given that the counterparty must be an ECP (and, in the case of a Special Entity, be represented by an independent advisor), but would also likely lead to confusion and litigation in instances where a counterparty believes or claims that the summary is inconsistent or incomplete when compared to the transaction documentation. Any such additional requirement would also be duplicative of the Commission's separate proposal requiring counterparties to exchange draft transaction acknowledgments prior to execution.<sup>46</sup> The Commission should harmonize its proposed requirements and eliminate this duplication in its final rules.

*D. Material Incentives and Conflicts of Interest*

PR 23.431(a)(3) would require an SD/MSP to provide a non-SD/MSP counterparty with disclosure reasonably designed to allow the counterparty to assess the SD/MSP's conflicts and incentives, including (i) with respect to disclosure of the price of a swap, the price of the swap and the mid-market value of the swap and (ii) any compensation or other incentives from any source other than the counterparty that the SD/MSP "may" receive in connection with the swap.

The requirement to disclose a mid-market value with the price for any swap is not mandated by Dodd-Frank. Additionally, as noted in other contexts, an obligation to provide a mid-market value is precisely the kind of communication that would transform an SD from a counterparty to an advisor. The CTA definition expressly includes a person that provides advice as to the value of a commodity interest. Given Dodd-Frank's unambiguous distinction between SDs that are counterparties and SDs that are advisors, it is simply not possible to reconcile this proposal by the Commission with Dodd-Frank and existing provisions of the CEA. We therefore request that the Commission delete the requirement to disclose a mid-market value with the price for any swap.

Also, the Commission should not require, as suggested in one of its requests for comment, that an SD/MSP disclose an anticipation of profit or gain resulting from other transactions in light of the current transaction.<sup>47</sup> Such a requirement would be inconsistent with congressional intent, as Congress considered this idea and rejected it when enacting Dodd-Frank.<sup>48</sup> Moreover, the focus on an SD/MSP's profits is, in our view, fundamentally misplaced. The best protection for counterparties is measured not by the profit of the SD/MSP but rather by the counterparty's (or its advisor's) review and selection of the best available pricing, including

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<sup>46</sup> See 75 Fed. Reg. 81519 (Dec. 28, 2010) at 81351.

<sup>47</sup> See Proposing Release at 80645.

<sup>48</sup> The text used as the base for the House-Senate conference on H.R. 4173 included a requirement that SDs and MSPs disclose "the source and amount of any fees or other material remuneration that the swap dealer or major swap participant would directly or indirectly expect to receive in connection with the swap," but that provision was struck during the conference process.

based on post-trade transparency available through Dodd-Frank's real-time public reporting requirements.

We also ask that the Commission withdraw the statement in the Proposing Release that SDs and MSPs "would be expected to disclose whether their compensation related to the recommended swap transaction would be greater than for another instrument with similar economic terms offered by the swap dealer or major swap participant."<sup>49</sup> SDs and MSPs should not be obligated to identify and evaluate comparable instruments on behalf of the counterparty. Rather, it should be the responsibility of the counterparty and its representative to ascertain and select the appropriate instrument, among the alternatives that are available. Investment managers are paid to perform these services. Their duties should not be diluted by requiring the SD/MSP counterparties to perform the advisory services that investment managers and other advisors are retained, or are available, to perform.<sup>50</sup>

*E. Daily Marks*

Under PR 23.431(c)(1), for swaps cleared on a derivatives clearing organization ("DCO"), an SD/MSP would be required to notify the counterparty of its right to receive a daily mark from the DCO. For uncleared swaps, PR 23.431(c)(2) and (3) would require an SD/MSP to provide the counterparty with a daily mark, which would be the mid-market value of the swap, as well as the methodology and assumptions used to prepare the daily mark.<sup>51</sup> We note that Dodd-Frank does not require disclosure by an SD/MSP of any swap value, including a mid-market value. Any such requirement would be inherently inconsistent with the distinction drawn by Dodd-Frank between counterparties and advisors. Instead, Dodd-Frank requires disclosure of a "daily mark."

In light of the concerns noted above that mandatory provision of mid-market values would obligate an SD to provide advice (with untenable consequences), we strongly urge the Commission instead to require an SD/MSP upon request by a counterparty, to provide the mark that it has used for determining either party's mark-to-market margin obligation/entitlement under an outstanding swap (for which purpose SDs/MSPs do and will likely continue to use a mid-market value).<sup>52</sup> This requirement would be consistent with the relevant statutory text and

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<sup>49</sup> Id.

<sup>50</sup> At a minimum, we respectfully request that the Commission clarify the potential scope of this obligation by (1) limiting it to DCM/SEF-traded swaps and (2) clarifying the range of "comparable" instruments as economically equivalent swaps traded on other DCMs/SEFs.

<sup>51</sup> We note that, consistent with Part I.B above, we assume that any "daily mark" requirement will not apply to existing swaps, since such retroactive application would contradict existing binding contractual arrangements (and would be particularly odd if, as it presumably will, the Commission confirms that Dodd-Frank's margin requirements will not apply retroactively to existing swaps).

<sup>52</sup> PR 23.431(c)(2)'s definition of a "mid-market value," which would exclude amounts for profit, credit reserve, hedging, funding, liquidity or any other costs or adjustments, would not in all circumstances provide the fair value of

the requirement to provide the counterparty with a DCO's daily mark in the case of a cleared swap, since that requirement is presumably intended to provide the counterparty with access to the settlement price used by the DCO to determine the level of variation margin (or "mark-to-market collateral") it is paying to or demanding of the holders of cleared positions.

Additionally, since the Proposed DOL Regulation provides that appraisals concerning the value of securities or other property are fiduciary advice, the Commission and DOL should coordinate their regulations so as to expressly exclude the provision of a daily mark from the definition of "an appraisal." The Commission should also obtain confirmation from the SEC that providing a daily mark will not subject an SD/MSP to municipal advisor registration. Similarly, the Commission itself should confirm that providing a daily mark would not constitute advice "as to the value of" a swap (and so should not subject an SD/MSP to CTA registration). Consistent with CEA Section 4s(h)(3)(B), the Commission should also confirm that daily marks would not need to be provided to a counterparty that is another SD/MSP.

### **VIII. Clearing**

PR 23.432 would require an SD/MSP to notify any non-SD/MSP counterparty of its right to elect to have a swap cleared (if not required to be cleared) and to select the DCO. We respectfully recommend that the Commission confirm that, where a transaction is not subject to a mandatory clearing requirement, an SD/MSP would not be required to clear a swap at a DCO at its counterparty's request, unless the SD/MSP is a member of the DCO itself or has a clearing relationship with a clearing member at that DCO. The Commission should also confirm that, while the counterparty has the right to select the DCO for clearing, the price of the swap may vary based on whether and where the swap is cleared. Margin custody arrangements entail costs and DCOs, for example, may have different margin requirements and cost structures, each of which could impact the SD/MSP's costs in entering into a swap transaction.

It is also important that the Commission clarify, pursuant to its rulemaking or interpretive authority, that the election of the counterparty to clear a swap is meant to be exercised at the swap's inception, provided of course that the SD/MSP has notified the counterparty prior to entering into the swap of its right to elect to have the swap cleared (if not required to be cleared) and to select the DCO. We believe that this is what Congress intended when it provided counterparties with a right to have their swaps cleared.

This clarification is important for three principal reasons. First, whether a swap is cleared or not will likely affect pricing. Additionally, permitting counterparties to elect clearing during the term of a swap could give rise to sudden and sharply increased credit exposures (e.g., where a counterparty elects to clear only or predominantly swaps that are in the money to it,

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the swap necessary for an accurate collateral call. Accordingly, we request that the Commission instead permit market participants to provide daily marks in any manner agreed by the parties.



leaving the SD/MSP to face the counterparty on only or mostly swaps that result in the SD/MSP having net credit exposure to the counterparty). Finally, the ability for SD/MSPs to continue to rely on netting arrangements for credit risk management, financial reporting, and capital adequacy purposes could be called into question if counterparties have acquired a statutory right that supersedes contractual netting provisions, reintroducing the risk of “cherry picking” that market participants and prudential regulators, both in the U.S. and abroad, have expended considerable effort to avoid.

### **IX. Institutional Suitability**

Although there is no statutory mandate for such a rule, PR 23.434(a) would require an SD/MSP that makes any “recommendation” of a swap or trading strategy to any counterparty (other than another SD/MSP) to have a “reasonable basis” to believe that such swap or trading strategy is “suitable” for that counterparty. The determination of suitability must be based on reasonable due diligence concerning the counterparty’s financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance, ability to absorb potential losses related to the recommended swap or trading strategy, and any other information known to the SD/MSP. Under PR 23.434(b), an SD/MSP would satisfy the suitability requirement if (i) the SD/MSP had a reasonable basis to believe that the counterparty (or its advisor) was capable of independently evaluating the risks related to the particular recommendation, (ii) the counterparty (or its advisor) affirmatively indicated that it was exercising independent judgment, and (iii) the SD/MSP had a reasonable basis to believe that the counterparty had the capacity to absorb potential losses related to the strategy.

We do not believe that this requirement is necessary or appropriate for the swap market. Given the prevalence of institutional suitability requirements in the U.S. securities markets and non-U.S. financial markets, as noted by the Commission,<sup>53</sup> Congress clearly could have determined to impose an institutional suitability requirement on SDs and MSPs generally. However, Congress did not do so except in the limited case of Special Entities, where Congress mandated that an SD/MSP must have a reasonable basis to believe that a Special Entity has a qualified independent representative.<sup>54</sup> For counterparties more generally, Congress determined only to impose a requirement that SDs and MSPs verify that every counterparty meets the eligibility standards for an ECP.<sup>55</sup>

If the Commission believes that an institutional suitability requirement is necessary, we strongly urge the Commission to implement such a requirement as an SRO rule, consistent with the model used by the Commission for this purpose. We believe that the a qualifying SRO would be well positioned to handle its implementation. We note that many

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<sup>53</sup> Proposing Release at 80647.

<sup>54</sup> CEA Section 4s(h)(5).

<sup>55</sup> CEA Section 4s(h)(3)(A).

counterparties will have no need for institutional suitability analysis from their SD/MSP counterparty and will find such a requirement to be intrusive and burdensome.<sup>56</sup> Accordingly, we recommend that sophisticated counterparties be permitted to opt out of this protection.

If the Commission does adopt an institutional suitability requirement, however, it must address a number of significant issues raised by the requirement as formulated in the Proposed Rules. In particular, we are concerned about the breadth of communications that could be considered “recommendations” that would trigger the suitability requirement and related affirmative diligence requirements.<sup>57</sup> The Proposing Release explains that a “recommendation” would include “any communication” by which an SD/MSP “provides information to a counterparty about a particular swap or trading strategy that is tailored to the needs or characteristics of the counterparty.”<sup>58</sup> Although PR 23.434(c)(2) includes exceptions for providing general transaction, financial, or market information or providing swap terms in response to a competitive bid request, those exceptions would not address other basic and common communications, such as providing swap terms in response to a non-competitive bid request.

The Commission’s proposal fails to acknowledge the very real differences in the types of communications that may occur between counterparties. The Commission’s proposal appears to assume that every “recommendation” is, in essence, a recommendation to the counterparty that the identified transaction is a transaction the counterparty should execute based on its circumstances. This is far from accurate. In many cases, the communication from the SD/MSP is no more than, “if you are looking to hedge or go long ‘x’ here is a term sheet for you to consider.” In that scenario, the SD/MSP is not recommending that the counterparty do anything, much less is it basing a recommendation on the tailored circumstances of the counterparty (assuming the Commission does not require that it do so in contravention of Dodd-Frank). Moreover, in those circumstances the counterparty is not looking to the SD/MSP to advise it what to do, or to go through (and charge the counterparty for the cost of) the steps necessary for the SD/MSP to do so, particularly where the counterparty already has an advisor it has specifically engaged for that purpose.

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<sup>56</sup> Aside from the additional costs and delays, highly sophisticated counterparties would be required to disclose confidential and detailed information to the SD/MSP in order for the SD/MSP to satisfy its institutional suitability obligation.

<sup>57</sup> We are also concerned that the proposed suitability requirement would go beyond the analogous requirement under FINRA Rules (Rule 2111(b)) and require the SD/MSP to analyze independently the counterparty’s capacity to absorb potential losses related to the swap or strategy. Although an SD/MSP may evaluate similar considerations for credit risk management purposes, such an evaluation does not go to the suitability of the swap or strategy for the counterparty, but rather the likelihood that the counterparty will be able to meet its obligations to the SD/MSP in full when due. Such a requirement would not only force counterparties to disclose to SDs and MSPs detailed information that they would prefer to keep confidential, but would also force the SD/MSP to second guess the counterparty’s own professional advisor, who is better positioned than the SD/MSP to analyze the counterparty’s financial condition and circumstances.

<sup>58</sup> Proposing Release at 80647.

It is essential that the Commission acknowledge these distinctions if it is to avoid chilling the communications between SD/MSPs and their counterparties and cut off the flow of information and transactional alternatives that falls short of advice and that non-SD/MSP counterparties find extremely beneficial. The proposed suitability requirement would have this chilling effect because it would obligate the SD/MSP to make determinations based upon individual characteristics of the counterparty, and there is a risk that such a suitability analysis and determination could be viewed as individualized advice in connection with an ERISA Plan's investment decisions, which could result in the SD/MSP becoming a fiduciary under the DOL Regulations (or, in non-ERISA contexts, under common law). The proposed requirement raises similar concerns under the CEA's CTA provisions and Dodd-Frank's municipal advisor provisions.

If the Commission (or a qualifying SRO, as applicable) adopts a suitability requirement, it should address these issues by permitting SD/MSPs to rely, absent notice of countervailing facts, upon a counterparty's simple written representations, rather than imposing an independent diligence requirement. This would be consistent with existing SRO rules, for which it is customary for broker-dealers to rely upon a customer's written representations in forming a reasonable basis regarding an institutional customer's capabilities. It would also prevent SD/MSPs from being required to make the types of individualized determinations that could trigger fiduciary or other advisory status.<sup>59</sup>

Finally, in response to the Commission's request for comment, we strongly urge the Commission not to subject SDs to an explicit fiduciary duty when making a recommendation to a counterparty.<sup>60</sup> As noted above, as the term "recommendation" is currently proposed to be interpreted, ordinary course interactions would be deemed a "recommendation;" thus, SDs would almost always be subject to an explicit fiduciary duty. This is clearly the opposite of the result Congress intended when it rejected the imposition of a fiduciary duty on SD counterparties to governmental entities, pension plans, and endowments.<sup>61</sup> Imposing a fiduciary duty on SDs would also result in a blanket prohibition that would prevent SDs from transacting with ERISA Plans and, likely, other counterparties.

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<sup>59</sup> If the Commission retains an affirmative diligence requirement, then it is essential that the requirement be triggered only in cases where the SD/MSP provides advice or makes recommendations to a counterparty, pursuant to a mutual written agreement that such advice or recommendations will serve as a primary basis for the counterparty's investment decisions, and that the advice will be individualized based on the particular needs of the counterparty. This would prevent the suitability requirement from triggering fiduciary or other advisory status except in circumstances where that status reflects the actual nature of the parties' relationship. See also note 38.

<sup>60</sup> See Proposing Release at 80648 (requesting comment on this topic). We note that scholars such as Professor Larry E. Ribstein have noted that the "fiduciary category should be confined to open-ended delegations of control in order to best serve fiduciary duties' functions." See Larry E. Ribstein, Fencing Fiduciary Duties, Illinois Program in Law, Behavior and Social Science Working Papers Series Working Paper No. LBSS11-01 (Jan. 2011), available at <http://ssrn.com/abstract=1737948>.

<sup>61</sup> See note 12, supra.

## **X. Execution Standards**

PR 155.7 would require SDs and other Commission registrants to execute a swap, if available for trading on a DCM or SEF, on terms that have a “reasonable relationship” to the best terms available. To satisfy this “reasonable relationship” test, a registrant would have a duty to exercise reasonable diligence to ascertain which DCM or SEF offers the best terms available for the transaction, including even those markets in which the registrant does not have trading privileges.

This proposed execution requirement is not mandated by Dodd-Frank. As with the institutional suitability provision discussed above, Congress clearly could have imposed one of many best execution or other relevant standards on SDs and other registrants if it believed it necessary or appropriate to do so; it did not. Nor did Congress indicate any intention to impose on the swap market a national market system of the type that forms the basis for FINRA’s best execution standards. Rather, Congress envisaged a market where sophisticated ECP counterparties would determine whether and at what price to enter into swap transactions based on pre-trade transparency available through DCMs and SEFs and post-trade transparency available through real-time public reporting.

The Commission describes its rationale for the proposed execution requirement by analogy to execution requirements in place in the securities markets.<sup>62</sup> The current sale of a fungible security or other asset is manifestly not, however, analogous to entering into a bilateral, executory, credit-sensitive swap. In particular, the price at which a registrant is willing to enter into a swap is not only a function of prices available in the market, but also its own appetite for assuming the relevant risk to the counterparty, as well as the relative profitability of other alternatives for the utilization of its credit capacity with the counterparty, as well as what exposure the registrant has to the underlier in its portfolio.<sup>63</sup> Risk management and other considerations are also often relevant, such as the relationship between swap terms and the profile of the registrant’s overall portfolio at the time. For instance, an SD may offer a better price than otherwise for a swap that flattens out the SD’s portfolio (or otherwise achieves a pre-existing trading objective).

Other aspects of the analogy to requirements in the securities markets do not hold up under closer scrutiny. Unlike the Commission’s proposed execution requirement, broker-dealers’ duty of best execution is not a transaction-by-transaction standard, but rather is discharged by a regular and rigorous review of transactions and market centers over a period of

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<sup>62</sup> Proposing Release at 80648.

<sup>63</sup> For instance, FINRA’s “mark-up” policy for fixed income securities relies heavily on evaluating the fairness of the price to the customer by comparison to the broker-dealer’s own contemporaneous cost or proceeds for selling or buying the security. NASD IM-2440-2. Counterparty credit risk considerations in the context of bilateral swaps necessarily mean that any sort of comparison based on “contemporaneous cost or proceeds” would be highly inaccurate.

time.<sup>64</sup> Moreover, broker-dealers conduct that analysis in the context of significant market infrastructure, including, in the case of equity securities, a Congressionally-mandated national market system. As noted above, no such infrastructure yet exists for swaps, nor did Congress contemplate one.

Accordingly, we believe that the execution requirement is neither feasible nor advisable in the context of the swap markets, at least today, and we urge that the Commission not adopt this requirement.<sup>65</sup>

## **XI. Special Entity Provisions**

### **A. Definition of “Special Entity”**

In response to the Commission’s request for comment as to whether clarification of the definition “Special Entity” is necessary, we propose the following clarifying changes.<sup>66</sup> These changes will mitigate the current ambiguities in the “Special Entity” definition and facilitate market efficiency.

- **Collective investment vehicles.** The Commission should clarify that collective investment vehicles do not become Special Entities merely as a result of the investment by Special Entities in such vehicles. Examples of such vehicles include bank collective trust funds that consist of assets of unrelated pension plans<sup>67</sup> and investment funds that are more than 25% held by ERISA plans and thus subject to ERISA.<sup>68</sup> The plain language of Dodd-Frank reveals the congressional intent to cover only employee benefit plans that act as counterparties to SDs and MSPs.<sup>69</sup> Indeed, it would be impossible for an SD/MSP to discharge the duties imposed on it by Dodd-Frank to every entity that participates in a collective investment vehicle. Furthermore, since collective investment vehicles typically include a range of investors, including those that are not subject to ERISA, the inclusion of collective investment vehicles in the definition of Special Entity would

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<sup>64</sup> See NASD Notice to Members 01-22 (Apr. 2001).

<sup>65</sup> At a minimum, we believe that such a requirement should be fostered at the SRO level. A qualifying SRO will have a more meaningful opportunity to consider the need for any such requirement and the appropriate manner in which to accomplish it based on an understanding of the developing market structure following the implementation of other Dodd-Frank requirements.

<sup>66</sup> Proposing Release at 80649.

<sup>67</sup> See, e.g., Section 3(c)(11) of the Investment Company Act of 1940; Section 3(a)(2) of the Securities Act of 1933; and CFTC Regulation 4.5 (each providing applicable exclusions for bank collective trust funds).

<sup>68</sup> See ERISA “Plan asset regulation,” 29 CFR § 2510.3-101.

<sup>69</sup> See CEA Section 4s(h)(2)(C)(iii) (defining “Special Entity,” in relevant part, as “any employee benefit plan”).

inappropriately extend the additional Special Entity protections to investors that do not seek or need such protections.

- **Master trusts.** The definition of “Special Entity” should encompass master trusts holding the assets of one or more funded plans of a single employer. Many employers combine one or more of their own pension plans into a master trust. Indeed, the assets of plans subject to ERISA’s fiduciary responsibility requirements are generally held by a separate trust and such a trust would typically enter into swaps with a counterparty. Such plans should also receive the protections provided by Dodd-Frank.
- **Plans not subject to ERISA.** The Commission should specify that plans that are not subject to ERISA should not be encompassed within the employee benefit plan prong of the “Special Entity” definition. Only those plans subject to the fiduciary responsibility provisions of ERISA—such as funded pension and welfare plans where assets are held by trusts and that are subject to extensive investment regulation by the DOL—should be included in this prong, a result which we believe is consistent with congressional intent. Since Congress included a separate “governmental plans” prong in the definition of Special Entity, the “employee benefit plan” prong necessarily excludes governmental plans (both domestic and foreign) and should be read narrowly to include only employee benefit plans subject to ERISA. While the “governmental plans” prong of the Special Entity definition would cover U.S. governmental plans, the Special Entity definition should exclude (i) unfunded plans for highly compensated employees; (ii) foreign pension plans (including foreign-based governmental plans); (iii) church plans that have elected not to subject themselves to ERISA; (iv) Section 403(b) plans that accept only employee contributions; and (v) Section 401(a), 403(b) and 457 plans sponsored by governmental entities.<sup>70</sup>
- **Endowments.** While “Special Entity” is currently defined under the Proposed Rules to include “any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986,” we respectfully recommend that the Commission address the scope of this prong of the “Special Entity” definition by clarifying that it is limited to an endowment that itself enters into swaps, including swaps to manage or generate returns for its investment portfolio, and does not encompass a non-profit organization, the assets of which may include an endowment or funds designated by it as an endowment. Healthcare, higher education and other non-profit organizations, as borrowers on a taxable or tax-exempt basis, are frequent users of swaps, including as hedges in connection with their borrowings. A non-profit organization’s swap may be

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<sup>70</sup> Presumably, this last category of plans would be covered under CEA Section 4s(h)(2)(C)(iv) and SEA Section 15F(h)(2)(C)(iv).

contractually payable from legally available sources, which may include funds designated by it as endowment, or from another identified source. The proposed clarification would exclude such a non-profit organization, a result consistent with the definition of “Special Entity,” which does not by its terms include non-profit organizations.

*B. Advisors to Special Entities*

Under PR 22.440(a), an SD would be deemed to “act as an advisor” on any transaction in which the SD recommends to a Special Entity a swap or a trading strategy that involves the use of swaps. This “recommendation” standard for whether an SD will be deemed to act as an advisor is not in Dodd-Frank. If the SD acts as an advisor, then PR 22.440(b) would require the SD to (i) act in the “best interests” of the Special Entity and (ii) make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap or trading strategy involving a swap recommended by the SD is in the best interests of the Special Entity.

In keeping with the congressional intent to distinguish SDs that act as advisors from those that are mere counterparties to Special Entities<sup>71</sup> and to ensure the free flow of information between SDs and the advisers to Special Entities, we urge the Commission, at a minimum, to create a safe harbor that provides that an SD would not be treated as an “advisor” where (1) the Special Entity has, or will have, an independent representative that is a sophisticated, professional adviser such as a bank, SEC-registered investment adviser, insurance company or other qualifying QPAM<sup>72</sup> or INHAM<sup>73</sup> for Special Entities subject to ERISA, a registered municipal advisor, or a similar qualified professional and (2) the transaction documentation confirms that the SD is not acting as an “advisor” and the counterparty is not relying on advice from the SD.

Furthermore, we ask the Commission to treat an SD as an “advisor” to a Special Entity only where the SD:

- provides advice to a Special Entity
- pursuant to a mutual written agreement that
- the advice will serve as a primary basis for the Special Entity’s investment decisions, and that

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<sup>71</sup> See notes 11-12, supra, and accompanying text.

<sup>72</sup> For the requirements that must be met by a Qualified Professional Asset Manager, see DOL Class Prohibited Transaction Exemption 84-14, 49 Fed. Reg. 9494 (1984).

<sup>73</sup> For the requirements that must be met by an In-house Asset Manager, see DOL Class Prohibited Transaction Exemption 96-23, 61 Fed. Reg. 15,975 (1996).

- the advice will be individualized based on the particular needs of the Special Entity.

Under this standard, an SD that merely complies with the business conduct requirements set forth in the Proposed Rules would not be an “advisor” to its counterparty, even where such an SD makes a “recommendation” in the context of a particular transaction. Such a standard would be consistent with the standards embodied in ERISA’s current fiduciary rules and would avoid inappropriately making the SD a fiduciary merely because the SD provides a required scenario analysis, conducts a required suitability assessment, evaluates the qualifications of its counterparty’s representative or otherwise complies with the requirements of the Proposed Rules.

These clarifications would also be consistent with common law and other statutory contexts that distinguish advice that is fiduciary in nature from advice rendered in the context of soliciting, structuring or executing a particular transaction.<sup>74</sup> We emphasize that the mere absence of a statutory exception from the definition of CTA for an SD whose advice is solely incidental to its activities as an SD does not provide a basis for subjecting an SD to a heightened “best interests” duty solely because of “recommendations” incidental to particular transactions.<sup>75</sup> Commission precedent clearly recognizes that it is the nature of the overall relationship between the customer and advisor—and the customer’s dependence on the advisor—that gives rise to a fiduciary relationship.<sup>76</sup> Imposing a “best interests” duty based only on recommendations in the context of particular transactions would effectively overturn this longstanding precedent.

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<sup>74</sup> See, e.g., Kwiatkowski v. Bear Stearns & Co., Inc., 306 F.3d 1293 (2d Cir. 2003) (explaining that, on a transaction-by-transaction basis, a broker owes duties of diligence and competence in executing the client’s orders but that the giving of advice on particular occasions does not trigger an ongoing duty on the part of a broker to advise in the future and monitor all data potentially relevant to a customer’s investment); SEC Staff Legal Bulletin No. 11 (Sept. 2000) (“The Division believes ... that Congress generally did not intend to apply the Advisers Act to any person who merely advises issuers concerning the structuring of their financings”); Division of Investment Management no-action letter David A. Kasich (available Mar. 19, 1992) (“the staff has stated that, in general, it does not interpret Section 202(a)(11) of the Advisers Act to apply to a person whose only advice consists of advising an issuer how to structure its financing”).

<sup>75</sup> Staff has suggested that Congress’s failure to include an “incidental” exemption from CTA regulation for SDs somehow signaled Congress’s intent that SDs be subject to regulation as CTAs. We note preliminarily that Congress used the phrase “advisor” and not “commodity trading advisor” in the relevant provisions of CEA Section 4s(h)(4). That distinction alone indicates that Congress likely regarded the provisions regulating CTAs as unrelated to the provisions of CEA Section 4s(h)(4). Whether or not that in fact reflects Congress’s intent, the absence of the cited incidental exemption for SDs simply is not relevant. The fact that Congress did not exempt SDs from CTA regulation under an incidental exemption—when their activities brought them within the definition—in no way means that Congress intended SDs to be CTAs (or advisors) per se. If that were the case, Dodd-Frank would have simply required SDs to register as CTAs, without more. The question therefore is what activities make an SD an advisor.

<sup>76</sup> See In re Jack Savage, CFTC Dkt. No. 78-1, Comm. Fut. L. Rep. (CCH) ¶20,139 (Mar. 1, 1976) (affirming decision and order at ¶20,082) (“[T]he customers of commodity trading advisors may depend solely on the advice of the commodity trading advisor in entering into transactions that are subject to the jurisdiction of the Commission.



With this context in mind, it is clear why Congress did not provide SDs with an “incidental” exclusion from the CTA definition comparable to the exclusions for FCMs and banks: FCMs and banks regularly manage customer accounts and in so doing establish advisory relationships. In contrast, SDs, as counterparties, do not.<sup>77</sup> An incidental exclusion would have been odd because “advice” is not customarily provided incidentally to “dealing” activity. Indeed, it is customary for parties to a swap to acknowledge expressly in the transaction confirmation that they do not have an advisory or fiduciary relationship.

Moreover, an SD’s activities as a counterparty in negotiating and entering into transactions do not mean that the SD “engages in the business of advising others . . . as to the value of or advisability of trading in” swaps.<sup>78</sup> When an SD provides a quote to a counterparty for a swap or structures and proposes terms for a swap at a counterparty’s request, it is indicating the price and other terms upon which it would enter into the swap as principal, not advising as to the value of the swap or the advisability of entering into the swap. When an SD provides a mark to a counterparty for a swap, it is indicating the level for determining the mark-to-market margin obligation/entitlement under the swap, not advising as to the value of the swap. Similarly, in preparing a term sheet, recommending a swap for consideration by a counterparty, and in other similar conduct, an SD may well not be providing advice as to the advisability of entering into the relevant swap transaction. In these instances, the SD is no more acting as an advisor to its counterparty than a car dealer is acting as an advisor to a prospective car buyer when the car dealer tells the buyer the price and options available for a particular model of car.

Furthermore, imposing a “best interests” duty based only on recommendations in the context of particular transactions would also, as a practical matter, leave SDs with no choice but to decline to provide Special Entities with any transaction-specific information tailored to the Special Entity, which would have the effect of chilling a critical element of the customary commercial interactions between Special Entities and SDs. In the municipal market, for example, this would disturb long standing market practices in which SDs, in the pursuit of swap business, regularly have: provided state and local governments and their advisors with information identifying swap market opportunities; proposed structures and products; and presented possibilities to amend, extend or terminate existing transactions. Such information has been

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This is a fiduciary relationship ...”) (emphasis added). This is also consistent with applicable SEC precedent. See Arleen W. Hughes, SEC Release No. 34-4048 (Feb. 18, 1948) (the “very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty to act in the best interests of [clients] and to make only such recommendations as will best serve such interests.”).

<sup>77</sup> We agree with the Commission that, when the SD does in fact have an advisory relationship with a party, then it should be required to register as a CTA.

<sup>78</sup> See CEA Section 1a(12) (defining CTA).

provided both in the context of informal discussions and pitches by SDs, as well as when state and local governments request structuring proposals as part of formal RFQ processes.

The fundamental change in the characterization of the business relationship between SDs and their counterparties embodied in the Proposed Rules would, in the case of state and local governments, have practical implications both in the context of the business conduct standards for SDs and under the municipal advisor registration requirements of Dodd-Frank. For example, a financial institution presenting alternative debt refunding structures to a state or local government on outstanding debt would customarily have considered including structures that do and do not involve the use of swaps. Following adoption of the Commission's Proposed Rules, the SD might not present the swap structures if by so doing it would risk the imposition of an advisory duty. Under the municipal advisor registration requirements as currently formulated,<sup>79</sup> work on the debt structuring, including presentation and review of tailored debt alternatives, would presumably fall within the underwriting exemption from the registration requirements and thus exclude such efforts from the fiduciary duty that attaches to municipal advisory services,<sup>80</sup> whereas presentation of the swap-based structures might trigger both a "best interests" duty and advisor status for the SD under the Proposed Rules and also a fiduciary duty under the municipal advisor rules.

We urge the Commission, together with the SEC in the context of the municipal advisor rules, to adopt a unified standard, predicated on the agreement and expectations of the parties, as described above, for recognizing when "advice" is being given. Multiple standards will, at a bare minimum, undoubtedly produce unnecessary compliance complications. More generally, under the Commission's proposals, if a Special Entity approached an SD and asked it for a term sheet for a customized swap addressing the Special Entity's particular hedging or investment objectives—objectives that the SD would, under PR 23.401(c), be required to learn—the SD would have to refuse the request, lest the SD be deemed an advisor. This is, of course, an absurd result, since as the Commission has observed, "[SDs] tend not to request that other parties propose the terms of swaps or security-based swaps; rather, [SDs] tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest."<sup>81</sup> Moreover, without the ability to exchange transaction information with SDs, Special Entities would effectively be prevented from engaging in any over-the-counter swap transactions.

We further urge the Commission, the DOL and the SEC to state definitively that no requirement or combination of requirements under the Proposed Rules would cause an SD (including an SD that makes a "recommendation" to a Special Entity) to be treated as a CTA, an

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<sup>79</sup> On January 6, 2010, the SEC published its proposed rule establishing a permanent and robust registration regime for municipal advisors. Registration of Municipal Advisors, Proposed Rule, SEA Release No. 63,576, 76 Fed. Reg. 824 (proposed Jan. 6, 2011).

<sup>80</sup> See Proposed Rule 15Ba1-1(d)(2)(i) under the SEA.

<sup>81</sup> 75 Fed. Reg. 80174 (Dec. 21, 2010) at 80176.

ERISA fiduciary, or a municipal advisor to its counterparty. This result is consistent with Congress's explicit rejection of a fiduciary standard for SDs, as well as with the Commission's own stated position that the Proposed Rules are not intended to preclude an SD from both recommending a swap to a Special Entity and entering into that swap with the same Special Entity.<sup>82</sup> In particular, if any requirement under the Proposed Rules were to make an SD a fiduciary to an ERISA counterparty, the SD would be prohibited from entering into swap transactions with that counterparty. Because of the draconian consequences of engaging in prohibited transactions under ERISA (including rescission and excise taxes), SDs will not enter into any swaps with Special Entities subject to ERISA without absolute certainty that they will not be treated as fiduciaries to their counterparties in such swap transactions. SDs will also need clarity regarding their status under Dodd-Frank's municipal advisor provisions and the CEA's CTA provisions before transacting with other Special Entities.

For an SD subject to the "best interests" requirement, we also urge the Commission to allow such an SD to rely on written representations of the Special Entity to meet both its duty to act in the best interests of the Special Entity and its obligation to "make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap or trading strategy involving a swap recommended by the SD is in the best interests of the Special Entity."<sup>83</sup> As currently drafted, the Proposed Rules permit an SD to rely on written representations only to satisfy the latter requirement. However, it is illogical to permit an SD to rely on written representations to meet its requirement to "make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap or trading strategy involving a swap recommended by the SD is in the best interests of the Special Entity" yet forbid the SD to rely on such representations to meet its duty "to act in the best interest of the Special Entity."

### C. Counterparties to Special Entities

For an SD/MSP that "offers to" or enters into a swap with a Special Entity, PR 22.450(b) would impose a duty to assess the qualifications of the Special Entity's representative as well as the quality of the relationship between the Special Entity and the representative.<sup>84</sup> The Proposed Rules should be modified to permit the Special Entity simply to represent to an SD that it has a representative that meets all of the enumerated criteria. As currently drafted, however, the SD is permitted to rely on the written representations of a Special Entity only if:

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<sup>82</sup> Proposing Release at 80650.

<sup>83</sup> PR 22.440(b).

<sup>84</sup> We request that the Commission confirm that an SD/MSP that presents a Special Entity with debt or swap portfolio structures and ideas is marketing products that it is prepared to offer, but is not "offering to" enter into any particular transaction until it delivers a formal offer. This clarification is particularly important in the municipal market in order to preserve the ability for municipalities to evaluate a wide range of potential swap transactions from multiple SDs/MSPs.

- Such an SD has a reasonable basis to believe that the representations are reliable “taking into consideration the facts and circumstances of a particular Special Entity-representative relationship, assessed in the context of a particular transaction (emphases added);”
- The representations include information “sufficiently detailed” for the SD reasonably to conclude that the representative satisfies the criteria. “Relevant considerations” for this determination include a seven factor list, comprised of factors such as “the nature of the relationship” between the Special Entity and the representative, the representative’s capability to make hedging or trading decisions, and the general level of experience of the representative in financial markets.<sup>85</sup>

These limitations are not contained in Dodd-Frank. As currently drafted, the Proposed Rules would impede the prerogative of the Special Entity to choose its advisors and to make simple representations about its choices. The Proposed Rules would effectively require the SD to second guess the competence of the representative chosen. Furthermore, rather than fostering the Special Entity’s careful selection of its representative, the requirement would promote dependency on the SD’s assessment in cases where the Special Entity, not the SD, is best-situated to evaluate the qualifications of its own representatives. Indeed, such evaluations are inherently subjective, thereby putting the Special Entity in the awkward and untenable position in which different SDs potentially arrive at different conclusions with respect to the qualifications of the same representative. Additionally, the new obligations would also unnecessarily delay the execution of swap transactions and expose Special Entities to additional market risk.

We urge the Commission to permit greater reliance on the representations of the Special Entity regarding the qualifications of its chosen representative. As with other representations, SDs should be permitted to rely on a written representation by the counterparty as to the fact that the counterparty and/or its representative satisfies the standards required under the CEA and Commission Regulations, absent actual notice of countervailing facts (or facts that reasonably should have put an SD on notice), which would trigger a consequent duty to inquire further. Furthermore, we ask the Commission to establish a safe harbor that would permit an SD to conclude that the Special Entity’s representative meets the enumerated criteria if the Special Entity represents that it has an independent representative that is a sophisticated, professional adviser such as a bank, SEC-registered investment adviser, insurance company or other qualifying QPAM or INHAM for Special Entities subject to ERISA, a registered municipal advisor, or a similar qualified professional.

Furthermore, while the Proposed Rules as currently drafted set forth an eight-factor test that must be met by any representative of a Special Entity, we do not believe that all of

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<sup>85</sup> PR 22.450(d). We note that the Proposed Rules would not impose these limitations on MSPs.

the factors should apply to representatives of ERISA Plans. Instead, the only factor that should apply in the case of such ERISA Plans is the requirement that the representative be a fiduciary as defined in Section 3 of ERISA.<sup>86</sup> For fiduciary representatives of ERISA Plans, ERISA already imposes requirements similar to those enumerated in PR 23.450(b)(1)-(6) that ensure that ERISA Plans are adequately protected.<sup>87</sup> We believe that the imposition of additional qualification requirements under the Proposed Rules would be redundant and would add administrative costs to market participants without any corresponding benefits to ERISA plans.

PR 23.450(c) would also impose a new definition of “independence” for the Special Entity representative, under which the representative would satisfy the independence requirement if (i) the representative is not and was not (within the previous year) an associated person of the SD/MSP, (ii) there is no principal relationship between the representative and the SD/MSP, and (iii) there is no “material business relationship” between the SD/MSP and the representative (whether or not compensatory), which would include any relationship that “reasonably could affect the independent judgment or decision making of the representative,” with a one-year look back. Fees paid by the SD/MSP to the representative at the written direction of the Special Entity for services provided by the representative in connection with the swap executed between the Special Entity and the SD/MSP would not be included.

We respectfully request that the Commission revise the proposed “independence” and “material business relationship” standards to bring such definitions in line with existing and accepted definitions:

- **Independence.** Instead of imposing yet another distinct test, the Commission should adopt one of several other well-established and workable tests of independence (such as excluding all “affiliates,” as such term is defined under relevant precedent under the Securities Act of 1933 or the CEA). Furthermore, the Commission should coordinate any test that it uses with the test that will be adopted by the SEC in its forthcoming business conduct regulations. For example, SD/MSPs and independent fiduciaries wishing to rely on the QPAM exemption have to ensure that the fiduciary is independent of the SD/MSP under the independence criteria of DOL Prohibited Transaction Exemption 84-14. By

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<sup>86</sup> PR 23.450(b)(7) (requiring that in the case of employee benefit plans subject to ERISA, the representative must be a fiduciary as defined in Section 3 of ERISA).

<sup>87</sup> See, e.g., ERISA Sections 404(a)(1) (requiring ERISA fiduciaries to discharge their duties “solely in the interest of the participants and beneficiaries” of the plan and “with the care, skill, prudence, and diligence . . . that a prudent man acting in a like capacity and familiar with such matters would use”) and 406(b) (prohibiting an ERISA fiduciary from, among other items, engaging in self-dealing); Eddy v. Colonial Life Ins. Co. of Am., 919 F.2d 747, 750 (D.C. Cir. 1990) (“The duty to disclose material information is the core of a fiduciary’s responsibility.”); California Ironworkers Field Pension Trust v. Loomis Sayles & Co., 259 F.3d 1036, 1043 (9th Cir. 2001) (“When applying the prudence rule, the primary question is whether the fiduciaries . . . ‘employed the appropriate methods to investigate the merits of the investment and to structure the investment.’” (quoting Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th Cir. 1983))).

creating yet another test for market participants to understand and adopt, the Commission only increases the compliance burden imposed by the Proposed Rules without any corresponding benefit. Furthermore, the proposed standard is so broad and vague that SDs/MSPs wary of the consequences of misinterpreting its requirements will likely simply abstain from affected trades.

- **Material business relationship.** While we strongly believe that a new “independence” standard should not be adopted, if the Commission decides to use the definition set forth in the Proposed Rules, then it must, at a minimum, clarify the scope and meaning of a “material business relationship.” The current definition introduces a novel and vague standard that leaves open numerous questions and generates trade-inhibiting uncertainty. For example, if an affiliated broker-dealer is the underwriter for mutual funds managed by the investment adviser, would that constitute a material business relationship between the SD/MSP and the Special Entity’s representative? Generally, since the representative’s “independence” is a necessary condition for the execution of any swap, the proposed definition would be interpreted in a very conservative manner, which would preclude Special Entities from benefiting from the services of numerous qualified representatives.
- **Compensation.** The Commission should clarify the types of compensation that must be disclosed in order for the Special Entity to agree in writing that such compensation does not constitute a material business relationship. As currently proposed, the disclosure requirement is unclear and impossibly broad given the many points of contact between financial institutions. For instance, if an SD/MSP in its capacity as broker provided soft dollar research (completely unrelated to any swap transaction) to an endowment’s investment adviser, would disclosure of that soft-dollar compensation be required? We believe that the answer is no, and that the Proposed Rules should require some nexus between the compensation that must be disclosed to the Special Entity and the particular swap transaction. In particular, we ask the Commission to confirm that disclosure of any compensation received by the representative would not be required if the compensation paid by the SD/MSP to the Special Entity’s representative was completely unrelated to the swap transaction between the SD/MSP and the Special Entity. In the absence of this clarification, SDs/MSPs would be required to survey all business relationships with representatives to determine whether any compensation was paid, an onerous requirement that would necessitate the development of extensive and expensive new recordkeeping systems not currently in place, with virtually no benefit to Special Entities.

Finally, PR 22.450(e) would require an SD/MSP, if it determines that the representative of the Special Entity does not meet the qualifications set forth in the Proposed Rules, to make a written record of the basis for such determination and submit such determination to its chief compliance officer for review to ensure that the SD/MSP has a substantial, unbiased basis for the determination. If the Commission decides to retain this requirement, we respectfully

recommend that the Commission modify it to require review by the trading supervisor, who is in a better position than the chief compliance officer to make types of judgments called for by the rule. We also recommend that the Commission clarify what further consequences would apply to an SD/MSP's determination that a representative is not qualified. In particular, the Commission and the DOL should confirm that an SD/MSP's determination that a counterparty's representative is not qualified would not make the SD/MSP a fiduciary under the Proposed DOL Regulation, keeping in mind that, under the Proposed DOL Regulation, anyone who advises an ERISA Plan as to the selection of a manager to manage ERISA Plan assets would be treated as providing fiduciary advice. Furthermore, the Commission and the DOL should confirm that the SD/MSP's power to implicitly cause the Special Entity to replace its adviser, upon determining that the representative is unqualified, would not violate the QPAM prohibition on counterparties having power to hire or fire advisers.<sup>88</sup> Finally, the Commission should confirm that SD/MSP would not have any liability to the Special Entity or its representative as a result of its good faith determination that the representative is not qualified.

*D. Disclosure of Capacity*

PR 22.450(f) would require an SD/MSP to disclose in writing to a Special Entity "before the initiation of a swap transaction" the capacity in which the SD/MSP is acting in connection with the swap. Furthermore, if the SD/MSP engages in business with the Special Entity in more than one capacity, it would be required to disclose the material differences between such capacities in connection with the swap and any other financial transaction or service involving the Special Entity.

Although the scope of this requirement is not articulated in the Proposing Release, we ask the Commission to confirm that this requirement does not apply to all business ever conducted with the Special Entity but is instead limited to the disclosure of multiple business relationships connected to the swap. For example, if an SD/MSP is approached by a Special Entity to negotiate a swap on the S&P 500, the SD/MSP should not have to describe all other relationships with the Special Entity (for example, that it or its affiliate also provides brokerage, investment advisory and other services to the Special Entity) but would have to disclose only those relationships that are related to the swap being undertaken.

**XII. Political Contributions**

Although not mandated by Dodd-Frank, PR 23.451(b)(1) provides a ban on swap activity with a municipal entity for two years following any contribution to an official of such municipal entity made by the SD or any "covered associate" of the SD/MSP. The Proposed Rule imposes potentially onerous requirements on SDs who are part of financial institutions that are not, or will not be, subject to the regulations of the Municipal Securities Rulemaking Board (the "MSRB"). This additional burden on an SD/MSP whose only connection to a municipal entity is

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<sup>88</sup> DOL Prohibited Transaction Exemption 84-14.

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acting as its counterparty is unwarranted, and could lead many SD/MSPs to stop entering into swaps with municipal entities altogether. Accordingly, we respectfully request that the Commission delete PR 23.451.

If, however, the Commission believes it necessary to impose a ban on swap activity as provided in the Proposed Rules, we suggest that the Proposed Rules governing the political contributions of SD/MSPs parallel in certain respects, as described below, the regulations promulgated by the MSRB on political contributions made in connection with municipal securities business.<sup>89</sup> As a result, we ask the Commission to limit the rule's scope to SD/MSPs already covered by the relevant MSRB regulations. If the Commission is unwilling to limit the rule's scope as suggested, we ask the Commission to consider replacing as the triggering occasion for the application of the rule an "offer to enter into or enter into a swap or a trading strategy involving a swap" with a term—"engage in municipal swaps business"—more akin to the terms used in the relevant MSRB Rules, "engage in municipal securities business" and "engage in municipal advisory business." Likewise, we recommend that "municipal swaps business" be defined to mean "the execution of a swap with a municipal entity."<sup>90</sup>

Furthermore, we urge the Commission to narrow the definition of "solicit" as applied to any "covered associate" employee of an SD. As currently drafted, a solicitation would include any "direct or indirect communication by any person with a municipal entity for the purpose of obtaining or retaining an engagement related to a swap."<sup>91</sup> Since employees of a financial institution often communicate with a municipal entity about bond, swap and reinvestment structures simultaneously, the term "solicit" could implicate communication by employees of a financial institution that do not have a role in the swaps business and who are already regulated by the MSRB. We would recommend that the Commission narrow the definition of "solicit" to include only "any direct communication by any person with a municipal entity for the purpose of obtaining or retaining municipal swaps business."

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<sup>89</sup> MSRB Rule G-37(b) provides that "no broker, dealer or municipal securities dealer shall engage in municipal securities business with an issuer within two years after any contribution to an official of such issuer." See MSRB Rule G-37 Political Contributions and Prohibitions on Municipal Securities Business. The Proposed Rule does not, for example, include the analogous provision of MSRB Rule G-37 limiting the scope of the rule to municipal financial professionals "primarily engaged in municipal financial representative activities . . ." See also MSRB Proposed Rule G-42 Political Contributions and Prohibitions on Municipal Advisory Activities. Both "municipal securities business" and "municipal advisory business" are terms defined in the relevant rule. See MSRB Rule G-37 (g)(vii) and MSRB Proposed Rule G-42 (g)(vii), as applicable. SIFMA is currently preparing detailed comments on the MSRB's pay to play proposal and would be pleased to discuss those comments with the Commission at a later time.

<sup>90</sup> In addition, see supra note 84 for our statement of a necessary clarification to the term "offer to." This ambiguous concept would be removed from the provision with the inclusion of a definition of "municipal swaps business" as we propose.

<sup>91</sup> PR 23.451(a)(7).



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Finally, we urge the Commission to include a provision, parallel to the relevant MSRB rules, which specifies an operative date for the rule, such that it only applies to contributions made on or after its effective date.<sup>92</sup> This is necessary to clarify that the rule would not unintentionally ban swap activity as a result of contributions made during the pre-effectiveness period when many SD/MSPs did not, nor reasonably could have been expected to, have policies and procedures in place for pre-clearance of contributions by their employees.

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The Associations appreciate the opportunity to comment on the Proposed Rules. We would be pleased to meet with the Commission or its staff to discuss the contents within this letter and Dodd-Frank more generally. If you have any questions, please do not hesitate to contact the undersigned or our staff.

Respectfully submitted,



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Kenneth E. Bentsen, Jr.  
Executive Vice President  
Public Policy and Advocacy  
SIFMA



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Executive Vice Chairman  
ISDA

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott O'Malia, Commissioner  
Commodity Futures Trading Commission

Honorable Mary L. Schapiro, Chairman  
Honorable Kathleen L. Casey, Commissioner  
Honorable Elisse B. Walter, Commissioner  
Honorable Luis A. Aguilar, Commissioner  
Honorable Troy A. Paredes, Commissioner  
Securities and Exchange Commission

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<sup>92</sup> See MSRB Rule G-37(h) and MSRB Proposed Rule G-42(h).

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Phyllis C. Borzi, Assistant Secretary, Employee Benefit Security Administration  
Department of Labor

Lynette Hotchkiss, Executive Director  
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